CORPORATE GOVERNANCE IN THE 21ST CENTURY

Japan's Gradual Transformation

Edited by
Luke Nottage
Leon Wolff
Kent Anderson

Corporations, Globalisation and the Law

Corporate Governance in the 21st Century

CORPORATIONS, GLOBALISATION AND THE LAW

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Preface and acknowledgements

The ‘lost decade’ of economic stagnation in Japan during the 1990s has become a ‘found decade’ for regulatory and institutional reform. With nearly all areas of the ‘law in the books’ reviewed, revised and rewritten, the Japanese legal system is no longer the system that foreign commentators felt they were finally starting to understand by the 1980s. Nowhere is this more evident than in corporate governance. Corporate and securities legislation has been comprehensively revamped over 1993–2007, creating a more flexible and transparent regime for shareholders and managers. Financial markets law and regulatory institutions have changed, too, creating a new context for Japan’s ‘main banks’ as alternative or additional outside monitors of managerial performance in borrowing firms. Even the legislation surrounding labour relations has been amended, reinforcing the ‘lifelong’ security privileges for elite employee-stakeholders, yet also hastening the growth of other ‘atypical’ employment relationships. But how do such legislative reforms affecting key players in Japanese firms, covering areas central to the design of Japanese capitalism, play out in the ‘law in action’? Overall, this book argues that a significant ‘gradual transformation’ has occurred. Although this is evident also in other advanced industrialised democracies, such as Germany, Japan reveals especially complex interactions in the various fields that sometimes emphasise different ways of achieving such transformation.

The book integrates studies of lifelong employment, main bank financing, insider and outsider governance structures, closely-held companies, corporate law practice, and takeovers and M&A (mergers and acquisitions). The authors hail from diverse backgrounds and disciplines: practitioners and academics; lawyers and political scientists; early-career researchers and mid-career professors; Australian and Japanese (and, for good measure, American, Canadian and New Zealander, too!). They were brought together, along with almost 300 others worldwide, by the Australian Network for Japanese Law (ANJeL). ANJeL was created by the editors’ law schools to promote research, teaching and broader community engagement in Japanese law, especially in Australia.

Several of this book’s chapters stem from presentations at ANJeL’s annual conferences on Japanese law. These activities have been supported by the editors’ broader research grant from the Australian Research Council (DP450648) during 2004–07, ‘Traction or Turbulence in Japanese Regulatory Style? An Empirical Analysis of Commercial Law Reform Since the 1990s’.

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Luke Nottage, Leon Wolff and Kent Anderson
Sydney and Canberra, February of the Year of the Rat (2008)

Abbreviations

ACCJ	American Chamber of Commerce in Japan
AG	Aktiengesellschaft
APEC	Asia-Pacific Economic Cooperation
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
CEO	chief executive officer
CLERP	Corporate Law Economic Reform Program
CME	coordinated market economy
EMIL	external model of internal linkage
EPA	Economic Partnership Agreement
FDI	foreign direct investment
FIEL	Financial Instruments and Exchange Law
FSA	Financial Services Agency
FTA	free trade agreement
FTC	Fair Trade Commission (Japan)
GmbH	Gesellschaft mit beschränkter Haftung
G8	Group of Eight
IMD	International Institute for Management Development
LDP	Liberal Democratic Party
LLC	limited liability company
LLP	limited liability partnership
LME	liberal market economy
M	mean (average)
M&A	mergers and acquisitions
M&R	Miwa and Ramseyer
MBO	management buyout
METI	Ministry of Economy, Trade and Industry
MIAC	Ministry of International Affairs and Communication
MoF	Ministry of Finance
MoJ	Ministry of Justice
NGO	non-governmental organisations
NTA	National Tax Agency
REIT	real estate investment trust
SD	standard deviation
SEL	Securities and Exchange Law

SMEs	small and medium enterprises
SMEA	Small and Medium Enterprise Agency
TOB	takeover bid
TSE	Tokyo Stock Exchange
UNCTAD	United Nations Conference on Trade and Development
USTR	United States Trade Representative
WTO	World Trade Organization

1. Introduction: Japan's gradual transformation in corporate governance

Luke Nottage, Leon Wolff and Kent Anderson

Like other major post-industrial democracies around the turn of the 21st century, Japan is undergoing a 'gradual transformation' in socio-economic relations (Streeck and Thelen, 2005). Unlike the 'great transformation' that engendered the welfare state in the mid-20th century (Polanyi, 1944), the current shift is back towards more market-driven governance. Yet entrenched legal and social norms and institutions mitigate the pace and influence the direction of this shift. Consequently, the ways in which it occurs and the overall extent of the transformation vary among countries, although some identifiable patterns are emerging from this transition worldwide.

One common but relatively low-key means of effecting a 'gradual transformation' is 'layering'. This means adding new institutions to see whether innovations will percolate through to other fields (Streeck and Thelen, 2005a). In policy initiatives and practices in Japan, layering seems particularly popular. One recent example is the superimposition of new postgraduate 'Law School' (*hoka daigakuin*) programs on top of undergraduate legal education since 2004. This reform is aimed at boosting the quality and quantity of law graduates able to qualify as *bengoshi* lawyers, public prosecutors and judges (Miyazawa, 2007). A second example of newly layered institutions is the greater use of lay participation in legal arenas. For example, in 2009 Japan will introduce a quasi-jury system (*saibanin seido*) for serious criminal trials. This may, as promised by the reformers, have much broader ramifications for both criminal justice and civic engagement (Anderson and Nolan, 2004; Ambler, 2007). A third example is the introduction of more lay participation in civil trials. This trend can be seen in complex matters such as construction disputes and the new specialised Tokyo High Court for appeals in intellectual property disputes (Nottage, 2005a).

All of these wide-ranging reforms emerged from recommendations in 2001 by the blue-ribbon Judicial Reform Council (JRC). The JRC sought to transform Japan from a system based on *ex ante* regulation by public authorities into one involving more indirect socio-economic ordering based more on *ex post* remedies pursued primarily by citizens themselves. Yet implementation

of these radical proposals has been limited by incrementalist 'reformist conservatism' (Nottage, 2006b). More generally, gradualism characterises policy initiatives adopted by Japan dating back centuries, including key junctures such as the nation's re-opening to the West and the Meiji Restoration in 1868. Japan tends to delay reactions, shoring up anachronistic institutions and sometimes adding new ones. Either this succeeds in meeting the new challenges, or more radical changes become necessary. In the latter case, the gradual changes already implemented mean that the new situation evolves as a progressive step rather than a big leap (Gluck, 2007; see also Hunter, 2006).

Nonetheless, Japan is far from unique in its slow but steady responses to its economic woes over the 1990s. Other rich countries also tend to delay reforms in such situations, for various reasons (La Croix and Kawaura, 2006, pp. 32–3). First, accumulated wealth provides a buffer. Indeed, unlike Korea, Japan did not really perceive itself to face an economic crisis, except perhaps over the year or so following the failures of securities firms and a major bank in late 1997 (Cargill, 2006, p. 135). Second, rich countries recently have already committed to economic reforms and, therefore, see less need to initiate more far-reaching changes. Third, by their very nature in complex societies, institutions cannot be too pliant. Finally, there are now fewer successful models to emulate or adapt, compared with the situation facing Japan in the 19th century. Even the US has only regained economic momentum since the early 1990s. More broadly, social theorists like North (2005) also expect large-scale institutional change to be incremental (due to opposition from existing organisations to others that have adapted more readily to the new environment) and path dependent (shaped by the knowledge and skills that organisations have invested in).

Corporate governance is a topical area that provides a useful lens to test and apply such broader theories of socio-economic change, especially in Japan. During the boom times of the 1980s, the Japanese company was regarded as an attractive alternative to counterparts in the West, especially in the US. With its emphasis on employee welfare (notably, the guarantee of lifelong employment: Rebick, 2005), interlocked shareholdings (often among members of *keiretsu* or corporate groups: Okabe, 2002) and monitoring by a key debt financier (the 'main bank' system: Aoki et al., 1994), Japanese corporate governance was regarded as equally – if not better – suited to achieving strong business results than the 'insider' model emphasising shareholder primacy. But when Japan slumped into recession, the Japanese company was increasingly no longer regarded as a viable alternative.

Massive reforms to Japanese corporate and commercial law, culminating in the consolidated Company Law (No. 86 of 2005: Takahashi and Shimizu, 2005) and the 2006 amendments to securities regulations (outlined further

below in the Appendix),[1] promised a more market-responsive and transparent model of corporate governance. In the eyes of some, Japan capitulated to an 'Americanization' of key corporate governance institutions (Kelemen and Sibbitt, 2002). This trend was reportedly triggered by political fragmentation in the early 1990s, combined with economic liberalisation and more emphasis on legal services and the formal legal system.

Yet is this really the case? With Japan back to steady economic growth since 2002, and many new legal reforms firmly in place, it is timely to reconsider how Japanese corporate governance has changed during the era following the collapse of Japan's 'bubble economy' of the 1980s. Has Japan really reached the 'end of history' (Hansmann and Kraakman, 2001), forsaking its own institutions for a shareholder primacy model centred on more arms' length market-driven relationships? Or has there been evolution rather than revolution, perhaps even a salutary reaction to shareholder primacy (Iwai, 2006)?

Various authors in this book, as in other recent works (Blomstrom and La Croix, 2006b; Vogel, 2006; Aoki et al., 2007), generally conclude that there has indeed been a gradual transformation rather than radical upheaval. Shifts are occurring at various levels, however, and may reveal somewhat different patterns from those evident in other post-industrial democracies moving towards more market-based approaches. Nonetheless, proving such changes in corporate governance poses several analytical challenges. If only to make effective comparisons across insider- and broader stakeholder-based systems, the way companies are governed needs to be analysed not just in terms of the relations between shareholders and managers, the traditional concern of Anglo-American corporate law and corporate governance scholarship (Berle and Means, 1933). Relationships with further stakeholders also need to be considered, especially with creditors and core employees. Others include supplier firms and customers, the government itself, community groups and NGOs (especially in this era of corporate social responsibility or CSR: Keizai Doyukai, 2004; Welford, 2005). In particular, corporate governance scholars and practitioners have highlighted in Japan the important de facto roles played by main banks and core (lifelong) employees as monitors of managerial performance in many Japanese corporations (Nottage and Wolff, 2005). This book follows such an approach to corporate governance, thereby opening a

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[1] See (Oda, 2007) for a more detailed overview of most of Japan's new Financial Instruments Exchange Law (No. 65 of 2006); and <http://www.protiviti.jp/downloads/flashreport/JSOX_Flash_Report0221E.pdf> for a comparison between its regime for better internal control reporting (known colloquially as 'J-SOX') and the US Sarbanes-Oxley Act of 2002 (SOX). For more comprehensive introductions to the major corporate law reforms, and the 'evolution' of broader features of corporate governance in Japan, see respectively Fujita (2004) and Sarra and Nakahigashi (2002).

window onto contemporary capitalism generally, as well as its interaction with politics, law and social norms.

From a theoretical perspective, this allows our findings to draw on – and feed back into – the broader theory of 'gradual transformation' currently being elaborated by experts in political science and political economy (Streeck and Thelen, 2005a). This approach to corporate governance also raises important practical implications for the rising numbers of foreign investors, businesses trading with Japanese corporations, and policy-makers interested in tracking or guiding the changes underway in Japan. Thus, the book offers fresh and up-to-date perspectives on developments in Japanese corporate governance, especially in the early years of the 21st century.

The authors herein approach a range of interconnected topics drawing on their diverse backgrounds. They comprise practising lawyers as well as academics, interested in 'black-letter law' as well as wider social and political theory. They are familiar with developments not only in Japan and the US but also in Australia, Canada and Europe. Consequently, the chapters take seriously another methodological lesson for comparative corporate governance scholarship: the consideration – explicit or implicit – of multiple jurisdictions for comparison. Comparing just two, such as Japan versus the US, tends to lead to over-emphasising either their divergences or instead their similarities. In addition, the authors generally clarify and justify their choice of timeframe, since a longer timeframe may tend to highlight greater transformation. All consider both socio-economic context (often suggesting continuities) and black-letter law (often suggesting change). The authors also make clear any normative preferences for change over continuity, since this often colours others' assessments of what is going on in corporate governance in Japan today. Finally, some authors look closely at the processes of law reform, not just the specific outcomes. The idea here is that, even if the latter turn out to involve minor changes, a new process in policy- or law-making could indicate a significant transformation, particularly for future developments.

As well as elaborating such core methodological points, Nottage's Chapter 2 offers a critical guide to the burgeoning and increasingly divided literature in English regarding contemporary corporate governance in Japan. He questions two variants of the view that no significant change is occurring at all. One variant, propounded especially by John Haley (2005b), emphasises stasis in core employment practices and norms in large Japanese corporations. The other, advanced by Mark Ramseyer, argues that no change is occurring only in the sense that post-war Japan has been governed anyway by market forces. In his view, except perhaps for 'lifelong employment', key components of the conventional wisdom about Japanese corporate governance constitute myths or fables (Miwa and Ramseyer, 2006). Nottage introduces studies that rebut this iconoclastic and idiosyncratic account either directly (see also Freedman

and Nottage, 2006), or indirectly by revealing gradual changes in those conventional components of the system (for example, Aoki et al., 2007). Nottage's engagement with the more specific model of 'gradual transformation' proposed by Streeck and Thelen (2005b) as well as other work by political scientists (Gourevitch and Shinn, 2005) also results in a critique of the view, common among the financial press, that Japan has already achieved full-scale change and convergence on a so-called 'American model'.

Wolff's Chapter 3 looks more closely at labour relations, in particular, the system of lifelong employment for core employees. Lifelong employment has long been held out as not only the centrepiece of Japanese industrial relations but also an emblem of Japan's stakeholder model of corporate governance. After the decade-long recession in the 1990s and early 2000s, some commentators are now predicting its 'death' (or de-institutionalisation). Others, however, are insisting that the institution remains – and will remain – largely in place. According to Wolff, this raises the stakes in the debate. If lifelong employment is dying, does this signal the end of Japan-style stakeholder capitalism and the triumph of Western-style shareholder primacy? Or does the Japanese model still endure as a 'variety' of capitalism?

Wolff argues that lifelong employment has been abused as a metaphor of Japanese stakeholder capitalism. Lifelong employment is not a typical form of employment relations in Japan. Even in the minority of cases where it does exist, it is neither a benign form of employee welfare nor an inefficient practice that has brought corporate Japan to its knees. Nor is it naturally occurring – either as a cultural form of cooperative, communitarian capitalism or as the institutional constituent of an alternative economic design to self-equilibrating markets. Instead, it is a politically invented tradition, initially created to ensure industrial peace in post-war Japan and subsequently preserved to support Japan's ensuing regime of accumulation. The law has sustained this strategic choice by erecting a regulatory framework of 'flexicurity' – a balance between flexibility of working practices and security of employment tenure.

This alternative understanding of lifelong employment, Wolff suggests, allows a reinterpretation of recent developments in industrial relations in Japan. Employment patterns are clearly undergoing important changes. But the empirical data do not support conclusions of a convergence to a market-based, termination-at-will system of employment, nor the persistence of Japan-specific institutions and norms of employee welfare. Instead, a transformation is indeed taking place, one based on the intensification of existing regulatory modes of 'flexicurity'. This intensification might very well lead to a crisis in the labour–management nexus in Japan (as predicted, for example, by Blomstrom and La Croix, 2006a, p. 11), or perhaps even its wholesale overthrow. So far, however, no new political compromise has been struck.

Wolff's conclusions open up provocative theoretical challenges. First, since

'culturalist' and neo-institutional theories fail to explain the developments in industrial relations in Japan, new theories are needed to understand the dynamic change in Japanese legal and economic institutions. Second, since lifelong employment is a governance technique that is not universal, ahistorical nor neutral, new theories are required that take seriously the heterogeneous, transient and political dimensions of corporate governance. Third, since Japanese capitalism is a regime of accumulation like any other, yet with its own defined set of strategic choices, new analytical tools are called for to interpret the roots of the Japanese political economy (not just its institutional manifestations) and for reaching informed assessments about its normative value (not just calibrating assessments to Japan's fluctuating business cycle).

Puchniak's Chapter 4 turns to main banks, another major distinctive component conventionally associated with post-war corporate governance in Japan. He rejects Ramseyer's free-market theory by summarising empirical and case study evidence showing how Japanese banks systematically persisted in lending trillions of yen to 'zombie' firms at below-market interest rates to save them from bankruptcy over the 'lost decade' (1990–2002). A matrix of unique institutional incentives (such as capital–asset ratios required under the Basel Accord) made it worthwhile for banks, especially main banks, to engage in behaviour that Ramseyer would view as impossibly irrational. The survival of main banks over that difficult era suggests that they will continue to play a considerable role in Japanese corporate governance. Hopefully, they now enjoy once again a less perverse institutional environment. Yet banks face a new regulatory environment following the implementation of Japan's 'Big Bang' reforms in the late 1990s (outlined in this chapter's Appendix and in more detail by Kozuka, 2005, and Cargill, 2006). Banks are also increasingly subjected to scrutiny through the court system.[2] Further, the ongoing role for main banks as actual or potential monitors of their client firms depends on the evolving environment influencing core employees, shareholders and other key components of Japan's corporate governance system.

[2] For example, as noted in Kozuka's concluding chapter, the Supreme Court (28 January 2008) recently upheld the decision of the Sapporo High Court (2 March 2006, 1946 Hanrei Jiho, p. 128) establishing directors' liability regarding loans extended by the Hokkaido Takushoku Bank (which collapsed in 1997). As remarked by Takahashi and Sakamoto (2007, pp. 267–70) in the context of the High Court decision, many actions have been brought against directors of failed financial institutions, especially by the Resolution and Collection Corporation (RCC) set up by the government to help resolve Japan's banking crisis. The case law has tended to hold them to higher standards of care than directors of general business corporations. Courts in Japan (as in Germany, but not the US) have developed a version of the 'business judgment rule' that tends to scrutinise the substance of business decisions, not just the process by which they were reached and whether any conflicts of interests existed.

Matsui's Chapter 5 tells a relatively untold story, even in the vast literature in Japanese: corporate governance issues in closely-held firms. In Japan as elsewhere, the vast majority of indigenous companies are small in size and owned by a few shareholders, often a parent corporation or family members. As such, they command an important economic presence in the market and play a unique role in Japanese industry. The new Company Law provides a new future for the governance of smaller enterprises. Giving voice to an industrial policy aimed at promoting market entry for new, innovative venturers, the new law provides smaller companies with the ability to customise their management structures and *ex ante* share schemes to better suit their business needs. Smaller companies also generate unique types of shareholder conflicts in the form of minority oppression. Under the mandatory provisions of the old Commercial Code, the oppression remedy had limited scope (Shishido, 1990). However, under the new law with its relaxed share-class provisions, shareholders in smaller companies are able to be more strategic in their relations with one another. Courts may also start to turn to the emerging takeover jurisprudence for public companies in developing the oppression doctrine to resolve the conflicts that will inexorably emerge as a result.

Only then does this book turn to the more conventional concerns of Anglo-American corporate governance theory and literature: developments directly affecting public companies. Lawley's Chapter 6 adds an innovative qualitative study to uncover patterns in the limited uptake of the option offered to Japan's large corporations since 2004 of replacing a more German-inspired board system with a more Anglo-American 'committee-based' system (Puchniak, 2003; Gilson and Milhaupt, 2005). Such 'elective' corporate law reform, and its so far limited direct impact, provides another excellent example of the 'layering' method of achieving a gradual transformation, particularly in Japan.

Three chapters then focus on overlapping aspects of Japan's rise of hostile takeovers in recent years, prefigured in Matsui's chapter. The numbers remain very small, and no major Japanese company has actually been taken over (Puchniak, 2008). However, hostile takeovers remain a major area of debate and concern in the corporate and legal worlds, both within Japan and abroad.[3] Dooley's Chapter 7 identifies this controversial field as one where the Japanese courts have provided less guidance. Fewer cases have reached them, although there are some continuities with judgments resulting from a small run of takeover disputes in the late 1980s (Kozuka, 2006). Hostile takeovers also represent one of now very few areas which the legislature has still not

[3] See also, for example, Economist Intelligence Unit (2005), Schaede (2006), Takahashi and Sakamoto (2006) and Osugi (2007). Interestingly, hostile takeovers have emerged in Germany and continental Europe as part of those countries' own gradual transformations (Baum, 2005).

addressed comprehensively. Instead, 'soft law' reform has played a prominent role. A major impetus came from Guidelines released in May 2005 by the Ministry of Economy, Trade and Industry (METI) together with the Ministry of Justice (MoJ), following a report by METI's Corporate Value Study Group. They proposed a rebalancing between facilitating hostile takeovers (to directly or more diffusely promote better corporate governance in actual or potential target firms) and allowing certain defensive measures by directors and/or shareholders (to limit abusive 'greenmailing'). The Guidelines and some contemporaneous case law seemed to prefer the more flexible test favouring incumbent managers developed in Delaware (Milhaupt, 2005a), rather than Anglo-Australian law's much stricter protections for target shareholders and concomitant advantages for bidders (Nottage, 2008b). Dooley's main innovation, however, is his proposal for Japan to adopt and adapt a specialised tribunal outside the regular court system, modelled on the Takeovers Panels found in the English law tradition. This follows from problems facing Japan in relying on regular court processes, more independent directors, or informed shareholder participation. However, contrasting features of such panels in England and Australia (Armson, 2005), a speedier and more informal *process* may need to be counterbalanced in Japan by more formal *substantive rules* less favourable to target managers. That may also be necessary to assuage concerns particularly on the part of US investors, who are used to litigating takeover disputes through the formal court system – albeit before the expert judges and tailored processes in Delaware courts.

On the other hand, Japan's courts now seem to be diverging from the substantive law applied by their counterparts in Delaware. Chapter 8 by Kamiya and Ito, lawyers in Tokyo familiar with the US approach as well as experienced in many of Japan's recent hostile takeover disputes, highlights and questions a significant shift. In the recent *Bulldog Sauce* litigation, the first to go all the way to the Supreme Court (27 September 2007, 1983 Hanrei Jiho, p. 56), more weight was given to the role expected of target shareholders regarding defensive measures. Kamiya and Ito are sceptical about the ability of shareholders in Japan to make informed decisions on such measures, despite the dramatic rise of (especially institutional) foreign investors. It remains to be seen how far this line will be pursued by other Japanese courts. Already, the complex case law development lends weight to Dooley's call for a more streamlined and market-sensitive dispute resolution body that functions outside regular court processes.

It may also be significant that the 2007 judgments came in the wake of a second Report of the Corporate Value Study Group published on 31 March 2006 (Corporate Value Study Group, 2006). This appears to give much greater weight to disclosure, to minimise information asymmetry so shareholders can give informed consent to defensive measures proposed by the board. It also

explores existing and potential improvements in means for shareholders, especially institutional investors, to become engaged in this process. The Report compares approaches in the US, the UK and the rest of Europe, and generally refers to finding a balance between the interests of bidders and target shareholders vis-à-vis target management. Indeed, the Introduction (p. 1) refers to the original Report (Corporate Value Study Group, 2005) and the related Guidelines (METI and MoJ, 2005) as 'rules prepared by those who defend'. It then contrasts takeover rules and reviews developed by the 'acquirer's camp'. The Report mentions reviews by the Financial Services Agency (FSA) that resulted in the 2006 reforms to securities law (outlined in this chapter's Appendix), as well as a comprehensive set of 'Proposals Regarding Fair M&A Rules' issued in July 2006 by the Corporate Governance Committee of the ruling Liberal Democratic Party (LDP). It goes on to note that the Study Group membership was expanded, involving in particular more institutional investors, and that the Group 'held repeated discussions on rules' from the dual perspectives of the 'defensive side' and the 'acquiring side' (p. 2).

A closer comparison of the two Study Group Reports (Corporate Value Study Group, 2005, 2006) confirms, for example, that six members were added. Three represented securities firms (Daiwa, Nikko Citigroup) and the Pension Fund Association, but two others represented the Mitsubishi UFJ Trust and Banking Corporation (itself created in 2005 after a messy takeover battle) and a famous international investment bank (Lazard).[4] This may reflect an existing or emerging political battle involving very high financial stakes. A parallel would be the conflict during the 1960s in the UK, pitting blue-chip companies and merchant bank advisors against maverick hostile bidders and institutional investors. The latter won out and entrenched the UK City Code system from 1968. This not only enforced substantive rules highly unfavourable to target management, but also enforced them through a Takeovers Panel that relied on informal hearings and highly effective socio-economic sanctions (Armour and Skeel, 2007). A rather similar battle took longer to play out in Australia (Nottage, 2008b). Although the substantive rules also favoured bidders, vis-à-vis target management, a Takeovers Panel really only took over from the courts in 2000. It is also more formal in its operations than its UK prototype, and was recently subject to a further constitutional challenge for usurping 'judicial power'.[5]

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[4] The sixth new member was another law professor, joining two senior colleagues, as well as two professors of business. The original Study Group had included only one representative from securities firms, namely Nomura. Incidentally, as of February 2008, METI's website provides the lengthy second Report in full translation (Corporate Value Study Group, 2006).

[5] The High Court of Australia, however, restored the trial judgment and rejected

This may be making too much of the METI Study Group's importance, but it suggests the importance of politics as well as economics, particularly in the field of takeovers and M&A. Pokarier's Chapter 9 takes this notion much further, locating the field in the broader context of the latest page in the story of Japanese regulation of foreign direct investment (FDI). The government maintains a commitment to expanding inbound FDI towards the levels found in other major world economies, and Japan is now formally very open to FDI. Yet FDI has grown much more slowly than portfolio investment from abroad, and Pokarier points out that there remains widespread ambivalence within government and broader policy-making circles. Recent developments potentially adversely affecting foreign investors include considerable scope for deploying defensive measures against hostile takeovers, and some imminent expansion of screening and restrictions especially for certain sensitive sectors such as airports.

Pokarier tests this policy mix against three models of political markets where state actors supply policy compromises to frequently contending constituency demands, involving interests and ideas – including economic nationalist ideas. Some evidence can be found for and against each model. First, the 'privatisation of economic nationalism' involves the government pursuing FDI liberalisation abroad, including via burgeoning bilateral free trade agreements (FTAs), at the cost of formally liberalising Japan's own regime for investment from abroad. But the government devolves the task of minimising foreign control to Japanese firms themselves, via poison pills and so on. Secondly, and less duplicitously, the 'discretionary public interest' model further devolves to firms the broader decision about whether to promote or resist greater foreign ownership, just as it leaves to them the (often overlapping) decision whether or not to adopt a more Anglo-American committee-based corporate form. Thirdly, a 'discretionary private interest' model involves more complex contention between recognisable domestic constituencies for and against FDI liberalisation, mediated through the public policy process. Discretionary responses tend to be popular, but on this account (as in the other two) discretions are being devolved from the public to private sectors, revealing parallels to Japan's liberalisation in the 1960s. It is too early to conclude whether this will result in informal barriers or, underpinned by competition in product markets and other pressures on entrenched interests, facilitate the 'adaptive efficiency' identified by North (2005) as essential to economic

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this challenge: *Attorney-General (Cth) v. Alinta Limited* [2008] High Court of Australia 2 (31 January 2008), freely available via <http://www.austlii.edu.au>. Considerations included the informality of Panel procedures compared with regular courts, the requirement for Panel orders to be enforced through the courts (if contested), and so on. See generally Armson (2007).

growth. Meanwhile, this broader context for takeover activity and corporate restructuring underscores Japan's messy 'gradual transformation' since the late 1990s.

As Kozuka concludes in Chapter 10, teasing out further interconnections within all the authors' combined picture of corporate governance in Japan, it is clearly therefore over-hasty to decide that there has been an 'Americanisation of Japanese law'. This can be seen through his innovative analysis: a comparison of key features of Japan's largest companies in 2008 and 1988, and how these interrelate with various changes to laws and practices. Empirical analysis shows that many remain in the 'Top 40'. However, many companies are now organised through pure holding companies, after a post-war prohibition was abolished in 1997 in line with Japan's 'Big Bang' financial sector reforms. Further, many large companies have gone through divestitures and restructuring, reflecting and prompting successive corporate law reforms in that field since the late 1990s (summarised in this chapter's Appendix). Greater flexibility in corporate finance, another feature of the reforms, is evident in the remarkable displacement of banks and insurance from among the top three shareholders in today's blue-chip companies. Nominees, probably institutional investors (including ever-growing foreign investors), have taken their place. Among Japan's largest companies, greater diversity is also reflected in various shifts in employee numbers. On the other hand, corporate law reforms have had less effect in other areas, such as the committee-based corporate form and caps on directors' liability exposure. The impact appears more diffuse, as in the practice of downsizing boards of directors while introducing more executive officers. An emerging 'shareholder fundamentalism' in takeovers law may be tempered by shareholders still taking into account broader stakeholder interests, even when approving defensive measures submitted by the board.

More generally, this field and the areas such as directors' duties (Fujita, 2005) remain heavily based on case law developments, which are inevitably messier and more long-term in their impact. Such developments may come as a surprise for those who emphasise the continental European roots of Japan's civil and commercial law system. However, the role of Japan's formal court system in influencing policy and practices is also apparent in neighbouring fields. For example, growing activism since the late 1990s has constrained high-interest unsecured consumer lending, in turn impacting on Japan's core banking sector (Kozuka and Nottage, 2007, 2008). Nonetheless, Japan's Supreme Court is certainly not the US Supreme Court.

In sum, applying different perspectives and methodologies to analyse a set of interconnected topics, all our authors agree that Japanese corporate governance has been undergoing a gradual transformation especially over the last decade, but this certainly does not amount to a reverse 'great transformation'

now dismantling the welfare state. Such broad-based support for Japan's gradual transformation, moreover, accords with compelling accounts recently from experts in Japanese history or Japanese studies (Kingston, 2004; Blomstrom and La Croix, 2006b), and corporate governance (Vogel, 2006; Aoki et al., 2007), as well as political scientists and others comparing other post-industrial democracies (Streeck and Thelen, 2005a).

At first glance, those conclusions may not seem so exciting for readers familiar with the ever-expanding English-language literature on Japanese law (Baum and Nottage, 1998). That has tended to prefer 'grand theory' in various incarnations. Contributors to this book do not subscribe to the 'culturalist' view, still found in recent academic literature (for example, De Cruz, 2007, pp. 213–17) and especially in the popular press, asserting that the Japanese *don't like law*, due to traditional Confucian values. Nor are they completely convinced by the 'institutional barriers' perception that the Japanese *can't like law*, due to problems accessing the courts and so on, or the 'elite management' theory holding that the Japanese are *made not to like law* (Upham, 1987), since such barriers are maintained to constrain unpredictable socio-economic change. Nor do they adopt Ramseyer's more recent account, derived from neoclassical economics, that the Japanese *do like law* – rationally settling disputes out of court and otherwise behaving in accordance with the relatively clear shadow cast by the law.

Instead, analyses of the range of corporate governance topics in this book draw on some insights from each theoretical paradigm while criticising other aspects, and the analyses apply a range of techniques guided by the broader methodological strictures outlined in Nottage's Chapter 2. In these ways, they largely accord with recent 'hybrid theorists' in Japanese law studies, who find generally that the Japanese *sometimes like law, but sometimes don't* (Abe and Nottage, 2006). This book therefore joins what Anderson (2006) describes as 'the new generation' of scholarship on Japanese law and the economy.

APPENDIX

Table 1.1 Summary of Japan's corporate and securities law reforms since the 1990s

Year	Main corporate law developments	Main securities and financial markets law developments
1990	Liberalisation of some aspects of legislation for closely-held companies, but increased minimum capital bases	New tender offer bid rules Requirement to disclose shareholdings of 5% or more
1991		Prohibition on securities firms offering compensation to clients for trading losses
1992		Institutional Reform Law enacted: Securities and Exchange Surveillance Commission launched (but linked to MoF)
1993	Caps on court filing fees for derivative actions Introduction of a board of auditors in a large company Relaxation of the requirements for shareholders to exercise their right to inspect the books of the company	
1994	Deregulation of stock repurchase (lifting the prohibition for purposes of an employee's stock plan or cancellation of the stock by shareholders' meeting)	

Table 1.1 Continued

Year	Main corporate law developments	Main securities and financial markets law developments
1996		Liberalisation of corporate bond issuance
1997	Introduction of the stock option system Deregulation of stock repurchases (lifting the prohibition for purposes of a stock option plan) Deregulation of stock repurchases (simplifying the procedure by which public corporations can repurchase shares from the market, or by way of a tender offer bid Corporate restructuring (merger procedures) Increase of penalties against companies' payments to corporate racketeers (*sokaiya*)	(Major securities firms and a bank go virtually bankrupt)
1998	Deregulation of stock purchases (expanding available funds through a simplified procedure for a public corporation)	Anti-Monopoly Law amendments (enacted 1997) abolishing prohibition of pure holding companies extended to financial institutions Law for Securitisation of Specified Assets by Specific Purpose Companies (SPC Law) enacted Financial System Reform Law enacted: Financial Supervisory Agency launched (independent of MoF) Other laws enacted for financial markets reconstruction:

		• Easier entry into securities business: licensing becomes registration system; abolition of prohibition on securities firms engaging in non-securities activities • Securities firms allowed to offer asset management services (for example, 'wrap accounts') • Banks fully allowed to sell mutual funds; company-type funds and private equity funds allowed • New regulations for proprietary trading systems
1999	Corporate restructuring (introduction of share-to-share exchange and share-transfer procedures)	• Full abolition of fixed commissions for securities brokers (partially liberalised from 1994) • Full liberalisation of mutual entry among banking, securities and insurance industries through subsidiary or holding companies; reduced 'fire-wall' regulations
2000	Corporate restructuring (introduction of the 'demerger' procedure)	Consolidated (from 1999) and market-value accounting of financial assets, based on International Accounting Standards Liberalisaton of the SPC Law (renamed the Asset Securitisation Law) and the Securities Investment Trusts and Securities Investment Companies Law (renamed the Investment Trusts and Investment Companies Law, allowing Japanese versions of real estate investment trusts or 'REITs')

Table 1.1 Continued

Year	Main corporate law developments	Main securities and financial markets law developments
		Securities and Exchange Law (SEL) amendments: • Stock exchanges allowed to become for-profit organisations (companies) • Disclosure system liberalised to allow electronic filings (in effect from 2001) Financial Products Sales Law enacted (in effect from 2001): suppliers (including banks and securities) to explain risks in financial products, lower requirements for clients to claim damages for breaches
2001	Deregulation of stock repurchases (completely abolishing the prohibition, and lifting the ban on 'treasury stock') Deregulation of the minimum size of shares Simplification of the procedure relating to the reduction of statutory reserve fund Authorisation of the electronic documentation of corporate information Corporate finance (authorising the company to issue call options for its shares)	Legislation reforming securities settlement systems: • Dematerialisation of commercial paper • Centralised Securites Depositories permitted to incorporate

	Simplification of the procedure for stock options	
	Corporate finance (deregulation of the issuance of various kinds of shares)	
	Authorisation of the limitation of directors' liability	
	Improvement of the procedure for derivative actions	
2002	Creation of optional 'company with committees' modelled on the Anglo-American corporate governance system (in effect from 2003, first round of elections from 2004)	
	Creation of 'Important Asset Committee'	
	Relaxation of the requirements for super-majority voting at the shareholders' meeting	
	Corporate governance/corporate finance (introduction of class voting for the election of management)	
	Introduction of the registration system for lost securities	
	Simplification of the reduction procedure for legal capital and the mandatory statutory reserve fund	
	Deregulation of foreign companies	
2003	Deregulation of stock repurchases (simplified procedure for public corporations to repurchase shares on the market, or by way of TOB)	
2004	Electronic public notice system	Dematerialisation of corporate securities
2005	Consolidation of corporate legislation into new Companies Act (in effect from 2006), using modern Japanese language:	

Table 1.1 Continued

Year	Main corporate law developments	Main securities and financial markets law developments
	• Abrogation of *yugen kaisha* (similar to GmbH in Germany), now generally treated as *kabushiki kaisha* (KK or joint stock companies, like AG); introduction of *godo kaisha* (limited liability companies, quite like the LLC in the US) and *yugen sekinin jigyo kumiai* (limited liability partnerships, quite like the LLP); but • KK divided into large and small companies either category of which can be established as closely or publicly held (with large and publicly held companies requiring a more complex governance structure – including the option still of a board with committees – whereas closely held companies need not always treat all shareholders equally, statutory auditors can be limited to reviewing only financial statements and not business operations of directors, and all such officers can have terms extended for up to ten years) • For KK, optional accounting consultant (as an officer to assist directors in preparing	

	financial statements), only one director possible (instead of at least three), minimum capital requirement abolished, freedom to distribute profits whenever (not up to twice per annum) • Triangular mergers to allow the absorbing company in a merger to provide cash or other assets (for example, parent company stocks) to shareholders rather than issuing shares from the newly merged company (but full effect delayed for foreign companies until 2007)	
2006		Tougher enforcement of the SEL, especially penalties (in effect from July 2006) Takeover law amendments, such as: bids for more than 30% share must proceed by TOB, bidder can modify terms if target splits shares, target must express view on bid (but if it questions bidder, latter must respond), mandatory bid if more than 70% (in effect from December 2006) Replacement of SEL by the Financial Instruments Exchange Law (in effect from September 2007):

Table 1.1 Continued

Year	Main corporate law developments	Main securities and financial markets law developments
		• Scope broadened, for example, to cover more derivatives and collective investment schemes, to encompass businesses hitherto not regulated by the SEL • Better disclosure: quarterly reporting for listed companies, and internal compliance reporting (J-SOX) (in effect from 2008)

Note: Shaded corporate law reforms come from Bills submitted by individual politicians, not the government (traditionally, the MoJ).

Sources: for corporate law reforms: Nottage (2006d), updating Fujita (2004); for securities law reforms: JSRI (2004, pp. 327–51), Kanda (2005), Oda (2007).

2. Perspectives and approaches: a framework for comparing Japanese corporate governance*

Luke Nottage

In 2002, Japan began to emerge from its decade-long economic malaise (Katz, 2003; Ito et al., 2005). With the US confronting a rash of corporate collapses that raised concern about the merits of shareholder primacy and market discipline (Hill, 2005), Japan's economic revival posed an intriguing set of questions. Had Japan engineered its way out of recession by refashioning its laws and economic institutions along more American lines (Kelemen and Sibbett, 2002)? Alternatively, did the economic recovery of 'Japan Inc.' provide evidence of the robustness of its broader, stakeholder-oriented system of governance (Collison and Kozuma, 2002)? Does Japan's experience, in short, reflect the triumph of US-style shareholder-oriented governance, or the endurance of Japan's stakeholder-based model of capitalism (Nottage and Wolff, 2005)?

This chapter addresses these questions. It canvasses the burgeoning literature that seeks to describe and evaluate changes to Japanese corporate governance law and practice. Other contributors to this volume delve further into specific governance issues in Japan: lifelong employment (Wolff), 'main bank' monitoring (Puchniak), control and conflicts in closely-held companies (Matsui), management boards and committees (Lawley), and mergers and acquisitions (M&A: Dooley, Pokarier, and Kamiya with Ito). This chapter addresses big-picture trends. One reason is that this is the literature most non-Japan specialists are likely to encounter when engaging in comparative corporate governance research. It is also replete with widely divergent assessments of the transformation of Japanese corporate governance since the 1990s – so much so, that the literature is more likely to confuse than clarify. This chapter's critical review lends support to the assessment emphasising gradual transformation, in the context of methodological 'best practice' in comparative corporate governance research.

* This is an updated and considerably shortened version of Nottage (2006d), containing further references and thanks to many individuals.

Specifically, Section 1 introduces the different perspectives. One pair of views (Section 1.1) sees no or only minimal change. This is because either Japan remains a communitarian society with a cultural predisposition to prioritising stakeholder relationships, or, in the revisionist turn against such 'culturalist' explanations of Japanese law and society, Japan is a 'rational' society where market forces and shareholder primacy prevail (as you would reasonably expect in any major, capitalist economy). However, a second pair of views (Section 1.2) finds significant shifts towards shareholder primacy. One perception, more common among the foreign financial press, is that dramatic change is underway. Such Americanisation, it is said, is epitomised by the rise of M&A and especially hostile takeovers, driven by the likes of internet entrepreneur Takafumi Horie and ex-bureaucrat Yoshiaki Murakami. The other view is that there are significant moves towards shareholder primacy, yet a persistent influence from other stakeholders such as main banks, industrial groupings (*keiretsu*) and core employees.

The last-mentioned view is shaping as the most convincing. Change is clearly underway. Yet, as the arrests of Horie and Murakami in 2006 for securities law violations reveal, pre-existing economic institutions and norms have not withered and died. This is certainly affirmed by recent research by Curtis Milhaupt and Mark West, two leading scholars of Japanese law based outside Japan and prolific writers on corporate governance in Japan (Anderson, 2006). The view also finds support in broader research by political scientists and economists (Section 1.3), who conclude that patterns of 'gradual transformation' are also evident among other post-industrial capitalist societies (for example, Streeck and Thelen, 2005a). Finally, this analysis goes beyond charting a middle position among the divergent views in the literature. It paves the way to offering five broader methodological suggestions for developing more convincing studies on comparative corporate governance (Section 2).

1. CHANGE OR CONTINUITY IN JAPANESE SOCIETY, LAW AND CORPORATE GOVERNANCE? TWO TIMES TWO VIEWS

1.1 No Change

Debates about change and continuity have long divided scholars on Japanese law, society and corporate governance. One group of scholars holds that no or only minimal change is occurring in Japan. But this group is itself divided, applying two diametrically opposed perceptions about law and society in Japan to reach their common conclusion. Thus, some insist that Japan retains

a strong communitarian ethos, reflected in its legal and economic institutions. By contrast, revisionists argue that modern Japan continues to operate according to universal precepts of market economics, whereby individuals act rationally out of narrow self-interest.

1.1.1 Communitarianism and stakeholder governance

A persistent advocate of the communitarian perspective is Haley (2005b), who remains committed to the view that nothing new is unfolding in Japan. The corporate sector — like the public sector[1] – continues to give primacy to entry-level hiring and operates a central personnel office staffed by senior career managers who are responsible for recruitment, training, assignment and promotion of career staff. He maintains that this crucial feature of long-term employment in Japan (explored further in Wolff's Chapter 3) underpins a broader stakeholder approach to corporate governance and fits with Japan's ongoing communitarian approach to law and society (Haley, 1998).

Analysing changes over the 1990s, Dore (2000a) reaches quite similar conclusions, although recently he has become more circumspect than Haley. He concedes that 'employee sovereignty has shifted markedly towards shareholder sovereignty' and identifies 'the development of a market for corporate control' as a pressure point on Japan's stakeholder capitalism (Dore, 2005a, p. 443). He gives special significance to the judgment of the Tokyo District Court (30 January 2004, 1802 Hanrei Jiho p. 30) that required Nichia to award 20 billion yen to an employee for his invention of a process to make light-emitting diodes (LEDs: Dore, 2005b, p. 97). This judgment suggests the rise of individual rights over corporate community, a heightened role for litigation over compromise,[2] and a broader shift – perhaps even 'evolution' – towards market individualism. Nonetheless, Dore (2005a, p. 443) also emphasises that employment institutions affecting the careers of top managers, in particular, are still changing only slowly in Japan, even compared with Germany. This helps to insulate Japan's traditional means of motivating both honest and dynamic corporate managers, despite the fading

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[1] Compare, for example, Amyx (2004). She notes mid-career hires of specialists into the Financial Supervisory Agency (FSA), expanded into the Financial Services Agency in 2000), which was set up in 1998 as the centerpiece of a novel regime for financial markets regulation following turmoil in financial markets particularly from late 1997. Amyx also notes mid-career transfers and hires of specialists into the Cabinet Office, increasingly powerful since its inauguration in 2001. The background was a major renegotiation of the relationship between politicians and the powerful Ministry of Finance (MoF) following the defeat of the long-ruling Liberal Democratic Party (LDP) in 1993. See also Hori (2005).

[2] This is despite subsequent initiatives to reform the Patent Law (No. 121 of 1959, as amended) that served as the basis for the suit.

ideology encouraging trust-based relationships that had more directly underpinned such institutions.

In his most recent studies, Dore (2007) acknowledges that there has been a 'quiet shareholder revolution'. It has brought real threats of takeovers and much greater managerial concern with share price. Remuneration of directors, too, rose much faster than that of other workers as the economy regained momentum over 2001–04. Yet, like Haley and unlike several other observers stressing growing diversification, he maintains that there has been little revision of the bureaucratic internal promotion system for top managers. Thus, he concurs with Haley that Japan retains key infrastructure needed to (re)build stakeholder-based firms, although Dore now concedes that they have come under growing threat.[3]

Jacoby (2005c, pp. 11–12), drawing primarily on empirical research from around 2001, also concludes that a core aspect of corporate governance has not changed much since around 1980, at least for listed companies and compared with the US. He argues that Japanese companies remain relatively organisation-oriented, focused on long-term employees and broader stakeholders in their corporate governance, underscored by a high-status centralised human relations (HR) department. Jacoby aligns himself more with Dore's recent position, compared with Haley who implies that in 2004 the distribution or variance of Japanese firms – in terms of organisation- versus shareholder-orientation – remains virtually identical to that in 1980. Jacoby concedes some shifts toward more market-oriented firms and some loss of influence previously enjoyed by HR executives. However, he views the US as having moved even more strongly towards a market model over the last two decades (see Figure 2.1).[4]

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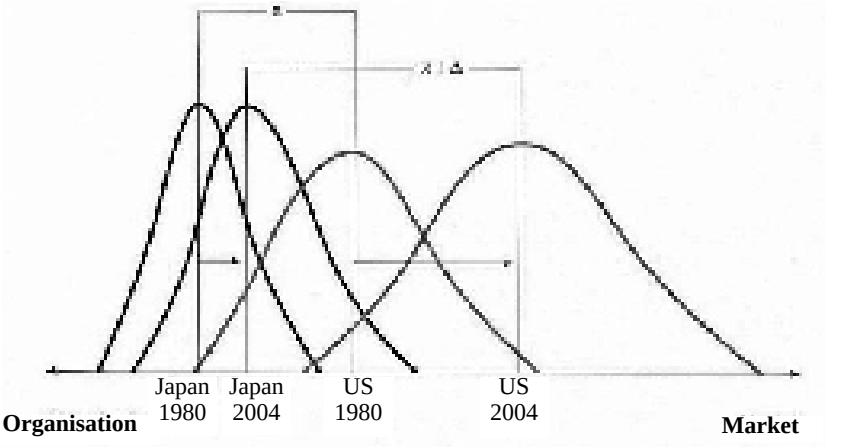
[3] See also Dore (2007). Compare for example Pudelko (2005a, p. 204). He concludes from his literature survey and large-scale survey research that remuneration 'is becoming increasingly differentiated, depending more and more on individual performance, although the difference between the pay of top managers and workers remains comparatively modest'. Inagami and Whittaker (2005) noted expectations of more merit-based promotions, in surveys conducted in 1999, and a shift to performance-based pay in their case study of Hitachi, even while increasing the staff training budget and other parts of a still community-oriented firm. See further generally Wolff Chapter 3, in this volume.

[4] Jacoby draws these bell curves for each country mainly just to depict roughly this effect. He does not provide extensive justification for why the distribution of firms in Japan remains narrower than in the US, or why each such distribution does not alter over the 24-year span. Nor does Jacoby explain why the shift in the 'average' Japanese firm over this period is as small as it appears compared with the shift in the average US firm. His main point is to illustrate his argument from other data that Japan's shift, towards more market-oriented employment and corporate governance, has been considerably smaller than that in the US.



Source: Jacoby (2005c, p. 158)

Figure 2.1 Organisation- v. market-oriented HR and corporate governance in Japan and the US

Although Jacoby's study purports to be about 'corporate governance', he focuses overwhelmingly on 'employment relations'. This is justified by the importance of relations between managers and employees for the governance of firms, especially still in Japan (as elaborated in Wolff's Chapter 3). Also important, however, are other relations that he hardly touches on in this study, particularly between the firms and their suppliers or creditors (compare for example Abegglen, 2005). In a more recent study, Jacoby (2007) nonetheless examines the impact of growing investment by the activist US public pension fund, CalPERS, into the Japanese share market since the 1990s. He concludes that CalPERS found traction in Japan with the help of some domestic allies, but succeeded primarily in encouraging more information disclosure rather than higher dividend payouts or the like. From 2002, the pension fund turned to more indirect 'relational investing' to extract greater returns. Thus, Figure 2.1 can be thought also as illustrating only a *limited* shift in Japan away from a broader stakeholder-based system of governance (x) towards a more shareholder-based approach. The latter approach, moreover, has reportedly gained even more traction in the US over the last quarter century ($x + \Delta$).

1.1.2 Rational self-interest and shareholder primacy

Like the communitarian theorists, revisionists led by Ramseyer agree that little has changed in Japan – but for very different reasons. Criticising communitar-

ian theorists for fundamentally misconstruing the true nature of Japanese law and society, Ramseyer instead submits that the Japanese have always been driven by rational self-interest. Further, the Japanese economy and corporate governance have been driven by straightforward market forces, not idiosyncratic and persistent institutional arrangements (Ramseyer and Nakazato, 1999; Miwa and Ramseyer, 2006). This is reflected in significant – albeit indirect – returns to shareholders even during the high-growth era after World War II when employee loyalty programs, such as lifelong employment and seniority-based pay, were presumed to take hold among larger Japanese companies (Kaplan and Ramseyer, 1996). On this view, observed shifts towards greater shareholder primacy in recent years are merely a move 'back to the future' of corporate governance in Japan (Miwa and Ramseyer, 2005a). Consistently, moreover, Ramseyer maintains that main banks – widely perceived as a key substitute monitor of managerial performance – were a Marxist invention (Miwa and Ramseyer, 2005b). Thus, reports of their persistence (notably by Puchniak in this volume), albeit possibly in decline, must be wrong; main banks simply never existed.[5] Ramseyer has not (yet) been bold enough to say that lifelong employment is also a pure fiction, but briefly decries this as a practice forced upon managers by a misguided legal system (Miwa and Ramseyer, 2006, p. 159).

For Ramseyer, Figure 2.1 above must be redrawn. The two bell curves representing the distribution of Japanese firms in 1980 and 2004 ('Japan 1980' and 'Japan 2004') simply vanish, becoming their US counterparts ('US 1980' and 'US 2004'). Alternatively, at the very least, they must be repositioned more closely towards the market end of the spectrum.

1.2 Change

Whereas the communitarians and rational choice theorists argue that Japanese corporate governance has changed little, if at all, a second group of scholars makes the opposite claim. Japan is departing from stakeholder capitalism and moving towards an embrace of shareholder primacy. Again, there are two major variants to this position.

1.2.1 Dramatic shifts towards market solutions and shareholder primacy

One view, shared by many in the Western financial press, emphasises dramatic change. This is epitomised by the editor of *The Economist*, who in 2005 – prior

[5] Compare also for example Milhaupt (2002); Arikawa and Miyajima (2007); and further literature outlined in Nottage (2005b).

to the arrests of Horie and Murakami – heralded the appointment of a Welshman to head the iconic Sony corporation (Emmott, 2005):[6]

> Cross-shareholdings have largely been unwound. Lifetime employment, even in big firms, is now the exception not the rule thanks to changes in labor laws that have allowed workers to be employed on short-term contracts. Such employees make up 40 per cent or more of the total at manufacturers such as Toyota. Many – though not all – corporate boards have been streamlined, with more independent directors and fewer placemen [sic]. . . . Executives remain primarily bureaucratic but there are now many more exceptions, sounding and behaving more like American CEOs and with senior management pay geared to performance. And foreign executives are no longer unacceptable.

Likewise, *The Economist* viewed the victory by the Liberal Democratic Party (LDP) in the snap election called on 11 September 2005 as an important further step towards restoring Japan as 'a normal advanced economy'. The key election issue was the liberalisation of Japan's vast postal savings system, which had traditionally provided funds for public works projects and epitomised the inefficient money politics characteristic of the ruling party over the 1970s and 1980s. The journal also saw the LDP's victory as an indicator of 'just how much the electorate has changed, and matured, over the course of Japan's dismal decade'.[7]

After the arrest of Horie, *The Economist* seemed to backtrack. In contrast to Dore, who acknowledged more shifts towards shareholder primacy in Japan, *The Economist* accepted the possibility of less pervasive change. It redefined Horie 'not as an innovative American-style capitalist, but rather a traditional Japanese book-cooker, one whose methods show that Japanese rules have changed too little, not too much'. Even so, *The Economist*'s proposed solution was to nudge Japan further in the direction of US law post-Enron (compare generally Hill, 2005). It urged further rules to:

> define the role and nature of an outside director, for example, to ensure equal treatment of all shareholders during a takeover bid or merger, to regulate the use of stock splits, and to make stricter demands about financial reporting of listed companies. Just as important, the means of enforcing existing and new rules needs to be strengthened.[8]

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[6] See also Dawson and Tashiro (2005). Emphasising the decline of cross-shareholding since the late 1990s, but hardly its complete 'unwinding', see also Okabe (2002).

[7] 'Special Report: Koizumi gets his way – Japan's election' 376 (8444) *The Economist*, 15 September 2005, p. 24. But see the Leader in the same issue, concluding that the LDP's moderate reformism belies 'a new Japan'.

[8] 'Saving Japan from the shadows – Japan after Livedoor', 376 (8463) *The*

Thus, in *The Economist*'s vision, clarifying and enforcing rules is really all that is needed to perfect a market-based system in Japan. The strengthening of securities law since mid-2006 appears to be giving effect to this vision.

The *Financial Times* drew similar – although more tempered – conclusions. It quoted Fujio Mitarai, the chairman of both Canon and Nippon Keidanren (Japan's leading business federation), as fulminating that 'a free economy without morality will head to catastrophe', and a US lawyer in Tokyo as opining that 'Japan in general relies so much on self-enforcement because Japanese are generally law-abiding'.[9] One implication might well be that ever-stricter rules encourage ever-greater deviance, by institutionalising suspicion and radical individualism instead of generalised trust and community (Dore, 2006).[10] However, writers in the *Financial Times* and the foreign financial press generally (for example, Tett, 2004) prefer that Japan and its corporate sector take the simpler and more familiar path to American-style profit-maximisation.

Again, it is helpful to conceptualise such conclusions in terms of Figure 2.1 above. Even in employment relations, *The Economist* would perceive a sharper shift by Japan towards the market end of the spectrum in recent years. The journal would broaden the scope of corporate governance to encompass other relationships such as those between firms and their financial institutions. Then, it would seem to argue for an even sharper shift towards more shareholder-driven corporate governance in Japan.

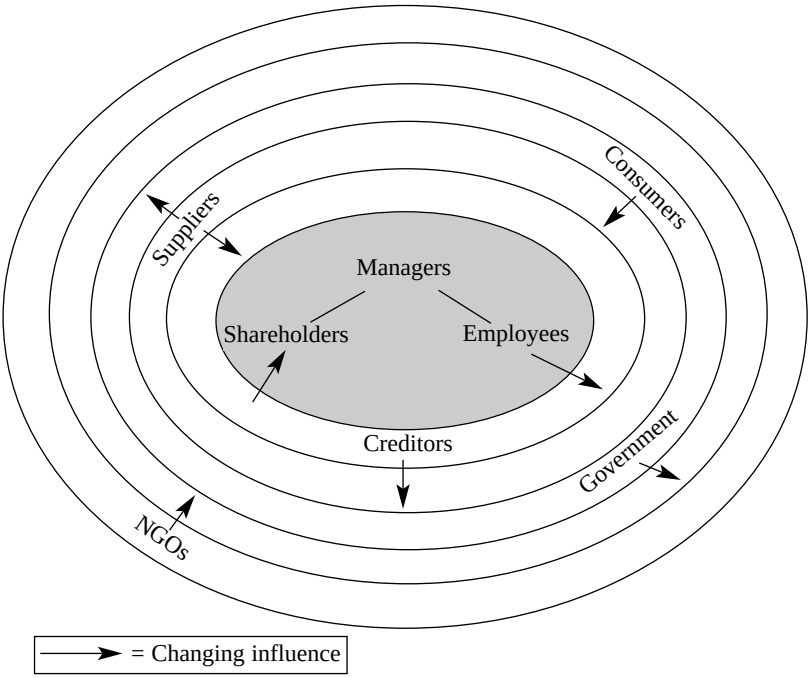
1.2.2 Significant shifts within the stakeholder model

Other commentators take a more guarded position on the extent to which Japanese law, society and corporate governance are changing. I am among them. My own work has found a considerable realignment of stakeholders.

Economist, 4 February 2006, p. 10. (But compare its subsequent assessments of 'slow but steady reform': 'Free At Last: Japan's Economy', 380 (8487) *The Economist*, 20 July 2006, p. 14; and of Koizumi's legacy – transformed governance and economic revival: 'The Man Who Remade Japan' 380 (8495) *The Economist*, 16 September 2006, p. 33.) Compare for example Editorial, 'A Generation Removed from Scandal', *Japan Times Online*, 1 August 2006 (emphasising differences between recent alleged crimes by entrepreneurs aimed at outwitting market regulations and scandals three decades ago like the Lockheed bribe scandal that embroiled then Prime Minister Kakuei Tanaka, involving collusion among politicians, bureaucrats and big business).

[9] Michiyo Nakamoto, 'Open Up? How the Livedoor Affair Could Change Japan's Opaque Corporate Culture', *Financial Times*, 30 January 2006, p. 17. Considerable law-abidingness does seem evident from recent comparative empirical studies of expectations and practices in contracting, contrary to much conventional wisdom: see for example Nottage (2008a).

[10] See also Nottage (2006c), outlining such critiques of ever-greater 'legalisation' presented by the prominent legal sociologist, Takao Tanase.



Source: Nottage and Wolff (2005, p. 133)

Figure 2.2 Shifting stakeholder influence in Japanese corporate governance

Shareholders have become more central compared with creditors and employees (with more change underway than acknowledged by Haley[11]). However, shifts are more ambivalent in some areas of industrial organisation (especially in relations with key suppliers[12]). Influences on firms from regulators or the broader community (such as NGOs) are also changing, but remain more peripheral. Figure 2.2 graphically represents these changes.

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[11] See also for example Kitagawa and Nottage (2007). This analyses survey data showing the growth of lateral hiring and specialisation, contrary to the pattern of generalist training and rotation around different departments, which Haley views as little changed and critical to stakeholder corporate governance in Japan. Compare also the further literature on this point introduced in Nottage (2005b).

[12] See also Ahmadjian and Robbins (2005b). They show empirically through to 1996 that auto manufacturers were already beginning to cut off suppliers linked by 'normative embeddedness' (general social norms), but that 'relational embeddedness' (interpersonal relationships, shared routines and so on) remained quite strong.

Such a multi-layered outcome (Sarra and Nakahigashi, 2002) – rather than straightforward institutional inertia – poses problems for overly monolithic views of divergent 'varieties of capitalism' (compare Hall and Soskice, 2001). It also means there exists a competing ideological model for (re)organising corporate governance. There remains scope for a more trust-building philosophy of 'learning by monitoring'. This may yet resonate in areas such as shareholder relations when compared with the currently preferred alternative that assumes a persistently 'trust-defying' *homo economicus* (Nottage, 2001).

Likewise, business 'network analysis' studies from the 1960s through to the 1990s confirm that the Japanese economy is reconfiguring itself in important ways, while stopping short of a revolution. On the one hand, corporate boards now including more outside directors, and *keiretsu* are undergoing a slow, uneven but inexorable dissolution. On the other hand, 'companies [are] still mak[ing] strategic and symbolic investments in one another and favour[ing] long-term, high-trust partnerships over short-term arm's-length ties' (Lincoln and Gerlach, 2004, p. 373).

Similarly, Ahmadjian (2007) emphasises considerable changes brought about by the rapid increase in foreign ownership of listed Japanese companies over the 1990s. By 2000, many non-financial firms, especially higher-performing and export-oriented large firms, had significant foreign ownership – increasingly concentrated in foreign (especially US) portfolio investors. Even institutional investors from continental Europe tended to promote Anglo-American notions of investment focused on maximising returns for shareholders. The liquidity of their shareholdings gave foreign shareholders growing influence through the threat of 'exit'. They also exercised 'voice' by disproportionately voting against incumbent management, but especially by more informal means (such as private meetings). This was correlated with investments in listed companies adopting more Anglo-American corporate governance practices such as board independence, transparency and disclosure.

Ahmadjian's study also builds on earlier co-authored work showing how rising foreign shareholdings over 1991–2000 relate to significant downsizing of permanent employees and asset divestitures. This signalled a shift towards shareholder-oriented corporate governance. However, the effects were less pronounced in firms more deeply embedded in the Japanese stakeholder system, namely those with high levels of ownership by domestic financial institutions or close ties with other firms. Ahmadjian and Robbins (2005, pp. 267–8) conclude by speculating that 'restructuring among foreign-owned firms may remove the perceived illegitimacy of these practices and encourage their spread to larger, older and more prestigious firms'. However, they concede the alternative possibility of banks and business groups continuing 'to check foreign influence, leading to an increased bifurcation between firms

exposed to foreign capital that adopt Anglo-American practices and those that remain tied to the Japanese system and maintain business as usual'. Drawing on his study of CalPERS, Jacoby (2007) suggests that asset divestiture is more likely to *attract* foreign investors, rather than them causing it. Abe and Shimizutani (2005) also find that the rising numbers of outside directors in Japanese firms are more inclined to implement layoffs and voluntary or early retirement, while insiders are more likely to decrease new hiring and protect incumbent employees.

Ahmadjian's work appears in a very recent collection (Aoki et al., 2007) whose other authors agree that considerable institutional change is underway. However, this change is generating complex diversity in corporate forms and functions, indicating that Japan is not simply being 'Americanised'. Aoki (2007, pp. 436–40) himself restates the basic features of three models derived from game-theoretic studies – (Anglo-American) shareholder sovereignty, (German) corporatism-codetermination, and the (post-war Japanese or 'J-type') relational contingent model – before sketching a fourth that might be emerging. Under this external model of internal linkage (EMIL), external capital markets play a stronger role. However, these markets monitor and promote productive internal relationships between a managerial business model and employees' human assets (rather than the firm's physical assets, the focus in the shareholder sovereignty model). Aoki suggests some parallels with the 'team production' approach to corporate governance advocated by Blair and Stout (1999).[13]

Jackson and Miyajima (2007, pp. 32–43) use cluster analysis of listed Japanese firms surveyed in December 2002 to conclude that EMIL-type 'hybrid' firms are indeed becoming more important. Firms oriented towards market rather than relational finance, yet retaining more relational employment and insider-based boards, represented only 24 per cent of firms but accounted for 67 per cent of total employment. Traditional or somewhat modified J-type firms, basically relational on all three dimensions, accounted for 42 per cent of firms but only 16 per cent of total employment. Some of the remaining 'inverse hybrid' firms tended to be quite J-type, albeit using merit-based pay (for example, some retail and auto industry firms); but others (for

[13] However, Shishido (2007, p. 326 n. 19) points out that under the latter approach the board is a neutral mediator among stakeholders. By contrast, in a model similar to Aoki's that Shishido sketches as likely to emerge due to still-illiquid labour markets and Japan's comparative advantage in manufacturing rather than financial markets, where less relation-specific investments are needed, 'directors play the role of delegates of either human capital or monetary capital providers, and bargain with each other to maximise the interests of their respective constituency and to motivate their counterparts to provide their capital'.

example, IT, retail, family-owned or smaller trading companies) were quite 'adversarial', with very low levels of lifelong employment and unionisation.

This distinct but complex transformation in Japan's corporate governance landscape is also confirmed by a qualitative study, dovetailing with the largely contemporaneous study that Lawley conducted and outlines in this volume. The study by Buchanan and Deakin (2007) was based on 24 interviews conducted in September 2006 with companies and other actors, most of whom had also been interviewed over 2003–04. Interview subjects were asked to compare governance practices with formal or informal structural changes introduced since 2001. They found that, although many changes were being made to make better use of external advice and to streamline management, these were not limited to companies that had adopted the Anglo-American management model of three governance committees supporting the board of directors and comprising a majority of independent directors (a model available since 2004 and described further by Lawley in Chapter 6).

Milhaupt and West, prolific commentators on corporate governance transformations in Japan, have generally tended to conclude that even more significant shifts are underway in Japan. Most of their work has focused on how Japanese economic and political actors have reacted quite rationally and predictably to the evolving formal (legal) and informal (other institutional) 'rules of the game' (Milhaupt and West, 2004). Thus, shareholder derivative suits were largely unheard-of in corporate Japan due their prohibitive cost, but this changed when the filing fee was dropped to a small set amount under a reform to the Commercial Code in 1993 (West, 1994, 2001b). The regime also had to be reconfigured in an attempt to develop a new market for venture capital (Milhaupt, 1997). Such shifts towards more shareholder-focused corporate governance were necessitated by the breakdown in Japan's 'convoy' system of banking and finance, whereby financial institutions moved at the speed of the slowest member supported by the implicit guarantee of government bailouts. The breakdown began with the housing mortgage debacle over the first half of the 1990s (Milhaupt and Miller, 1997), and was completed by the full-blown banking crisis of 1998 (Milhaupt, 1999). Before such transformations, shareholders needed to turn to organised crime syndicates to partially secure their investments (Milhaupt and West, 2000; West, 1999). Now, with new rules of the game leading also to a growing market for M&A, even the new generation of Japan's elite – graduates of Tokyo University Law Faculty – are forsaking long-term careers in key ministries to join rapidly expanding and increasingly specialised Tokyo law firms (Milhaupt and West, 2003). Overall, their studies indicate a shift from informal ordering towards formal rules or institutions, raising the profile of shareholders and undermining more diffuse stakeholder governance.

However, these studies do not fully examine *why* and *how* the rules of the

game change to effect these new patterns of observed behaviour. Although Milhaupt and West (2004) acknowledge their debt to the prominent political economist, Aoki (2001), their work does not pursue his conceptualisation of rules or institutions as 'endogenous rules of the game'. On that view, institutions not only arise from the interaction and stable expectations of socio-economic actors (a dependent variable at time *t*), but also guide and constrain actor behaviour (becoming an independent variable at time *t + 1*) (Amyx, 2004, p. 27).

Recent studies by political scientists, comparing key components of Japanese corporate governance, have been even more sensitive to such feedback loops. This, however, further complicates the quantitative analysis of causal patterns in historical development. Thus, Vogel develops a model involving macro policy reform modifying constraints on micro corporate adjustment, which modifies industry preferences for further policy reforms (Vogel, 2006, pp. 11–20). He also envisages concentric 'circles of rationality' driving firms and others acting within these cycles. These involve not only (i) financial cost–benefit analysis, but also (ii) institutional costs and benefits (varying over time and industry) and (iii) broader social/reputational costs and benefits. Moreover, these circles of rationality involve even broader (a) belief systems and identity and (b) political institutions.[14]

Writing independently of West, Milhaupt has emphasised the role of 'norm entrepreneurs' such as Murakami and Horie, especially in breaking an informal taboo against hostile takeovers under the new legal and social rules of the game (Milhaupt, 2001). The activities of such actors certainly have attracted growing attention (Milhaupt, 2005a), although much of this has turned negative recently. Nonetheless, Milhaupt has only just started to investigate the factors generating such new rules. These include some of the more formal rules that, on the preliminary analysis in his co-authored book (Milhaupt and West, 2003), should be becoming more significant. For example, Kanda and Milhaupt first point out that the director's duty of loyalty transplanted into the Commercial Code (art. 254(3)) from the US in 1950 only became operational

[14] In broader comparative compass, for example, Gourevitch and Shinn (2005, pp. 16 and 23) argue that 'politics' such as electoral rules impact on 'policies', such as minority shareholder protections, which in turn result in shareholder diffusion (a key corporate governance 'outcome'); but also that a 'policy generates support for its continuance by eliminating its opponents and strengthening its beneficiaries and their commitment to the policy', creating a feedback loop from outcomes back to politics. Thelen (2004, pp. 290–91) is even less deterministic, suggesting in particular that the German evolution of employment skills system since the late 19th century shows how institutional complementarities can develop not just through positive feedback, but by actors actively adapting inherited institutions to new circumstances, interests or power constellations.

from the late 1980s (Kanda and Milhaupt, 2003). They explain the initial stasis by the existence of partial substitutes, notably the director's duty of care (in the original art. 254(3)). But they stress both a lack of 'micro-fit' (few avenues for derivative suits until 1993, and few judges and lawyers capable of applying broad principles rather than narrow rules[15]), and weak 'macro-fit' (private substitutes, such as crime syndicates, and lifetime employment practices in a high-growth economy). Presumably, such factors should work towards the enactment of new rules, not just the sudden operationalisation of dormant black-letter law.

Instead, Milhaupt (2006) has argued that a major determinant of corporate law changes over the last decade has been the growing power of Japan's managers and their lobbyists, since so many are enabling rules providing extra flexibility. Such provisions can be used for the benefit of shareholders and the company as a whole, but also to insulate managers themselves.[16] Shishido (2007, pp. 313–24) updates his earlier similar argument to conclude that flexibility-enhancing 'demand-pull' corporate law changes have indeed continued since 1997, a turning point in Japan's history of corporate law reform (marked by the first Bill submitted by a parliamentarian rather than the Ministry of Justice or MoJ). However, he argues that there also have since been more and more 'policy-push' reforms, including the government requiring or encouraging changes in corporate governance practices. Matsui (Chapter 5 in this volume) further unravels the complex interaction between 'demand-pull' and 'policy-push' reforms in relation to closely-held companies, a largely untold story in Japanese corporate governance literature.

Such views mean acknowledging that the politics of corporate law reform may be quite context-specific. This is one lesson I draw from Milhaupt's recent work on the effects of the 'elective' corporate governance reforms enacted in 2002 (explored further in Lawley's Chapter 6). Milhaupt's main focus is on how and why a small number of listed large companies have elected to replace the German-inspired regime of statutory auditors monitoring the board of directors with a 'US-style' regime of committees of (mostly outside) directors charged with nomination, compensation and audit of direc-

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15 The former seems more important than the latter, since Japanese legal practitioners have had few difficulties developing broad principles in other areas of law (such as 'good faith' in contract law), and a relative aversion to bright-line rules is consistent with the orientation of Japanese (and indeed US) law and legal institutions towards more substantive legal reasoning, at least compared with the English law tradition (Nottage, 2002; 2007 updates available via <http://www.law.usyd.edu.au/anjel/content/anjel_research_pub.htm>).

16 As we now know so well in the aftermath of Enron and its parallels in other countries such as Australia: Clarke et al. (2003); Hill (2005).

tors. Gilson and Milhaupt (2005) find a variety of reasons why different firms adopt this new alternative. Reasons range from signalling 'good governance' (typically, major firms with significant foreign ownership such as Sony[17]) to, conversely, using the narrow definition of 'outside' director to plant parent or sibling company directors on the new committees to increase control of a corporate group (for example, Hitachi). The latter is a technique that has more in common with orthodox German than with Anglo-American corporate practice.

Interestingly, however, Milhaupt links this hybrid outcome to a lack of clear vision by policy-makers as to which of the two options was preferred. Undoubtedly, in this analysis, this ambiguity arises from the 'turf war' between the MoJ and the Ministry of Finance (MoF) (Milhaupt, 2005b). The MoJ initially proposed simply one, committee-based corporate governance model, but the MoF supposedly objected on behalf of the business community. The main reasons given by the MoF involved problems about securing requisite independent directors and how such independent directors could be expected to operate in highly relational networks (a point explored further in Dooley's Chapter 7). However, the Ministry of Economy, Trade and Industry (METI) objected to imposing one corporate governance form on diverse organisations (Ahmadjian, 2003). Because METI is even more closely linked to general business-sector lobby groups, the inclusion of two options in the 2002 Commercial Code amendments seems to reinforce the hypothesis of Milhaupt (2006) about the growing political clout of such groups in corporate law reforms.

More broadly, it is very intriguing – and a departure from the old ways of reforming corporate law until the 1990s – that so many new players are involved in this policy-making process. The MoJ (traditionally charged with commercial law reform) now shares the field with METI (responsible for broader industrial policy) and MoF (bolstered by its jurisdiction over stock exchanges). The pro-business LDP Subcommittee on Commercial Law and the *Keidanren*[18] are exerting back-door influence, appearing on some reform councils (*shingikai*) or ministerial committees and promoting a growing number of private members' bills. Milhaupt's work also shows how such battles are often fought in the context of much greater media interest in corporate affairs and policy reform.[19]

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17 See also generally Ahmadjian (2003).

18 On the former, see Fujita (2004); on the latter, see Vogel (2006, pp. 92–4).

19 See also the possible tensions between institutional investors and merchant bankers reflected even within the Corporate Value Study Group (2005, 2006), outlined in this volume's introductory chapter. In addition, other studies also suggest the growing role of the media in both reflecting and shaping public concerns about commercial

Developments in those two fields also uncover varying degrees of judicial involvement in policy-making debates and legislative reform. Milhaupt highlights the role played by the courts in a recent study into the evolving regulatory regime for hostile takeovers in Japan (Milhaupt, 2005a). In *Nippon Hoso v. Livedoor*, the Tokyo High Court (23 March 2005, 1899 Hanrei Jiho, p. 56) affirmed the trial court's injunction that prevented the target broadcaster from issuing share warrants to thwart a hostile takeover by a Horie-led internet provider. As explained by Kamiya and Ito in Chapter 8 of this volume, this High Court judgment seemed to parallel the Delaware courts' approach developed in the 1985 *Unocal* case. That approach focused on the threat of target shareholder exploitation and the proportionality of the response by the target's management. Soon after the *Livedoor* judgment, a 'Corporate Value Study Group' set up by METI in August 2004 rushed to release a Report in May 2005, prompting METI and the MoJ to release joint Guidelines on hostile takeover defensive measures. As explained further in Chapters 7 and 8, the Guidelines drew considerably on US law.

The Delaware model has thus provided a compromise solution for Japan. It is more shareholder-oriented than the 2002 German Takeover Code, which the Study Group implicitly rejected. But, it is less pro-shareholder than the UK's City Code approach, which requires target firm boards to remain strictly neutral and obtain shareholder approval before installing more circumscribed defensive measures (Nottage, 2008b; Hill, 2008). Yet, rather than straightforward Americanisation of Japanese law, Milhaupt (2005a, pp. 2210–11) concluded that the judgment of the High Court in the Livedoor case 'could be the foundation for development of a *Unocal* rule with Japanese characteristics – preventing egregious entrenchment attempts by incumbent management, but sanctioning airtight defenses to protect a range of corporate interests that appear very broad from a U.S. perspective'.

Indeed, the actual outcomes in the *Livedoor* case (favouring the bidder) and further case law since mid-2005 (disfavouring target management entrenchment) suggest that Japanese courts are quite finely attuned to the 'gradual transformation' of Japanese corporate governance towards a more shareholder-oriented model, while still acknowledging broader stakeholder interests. If that transformation proceeds fairly consistently,[20] we may expect

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regulation more broadly, such as in product liability and safety regulation reform (Nottage, 2004b, 2006a) and consumer credit market re-regulation (Kozuka and Nottage, 2007, 2008).

[20] The evolution of takeovers law tends to be fact-specific and therefore messy, especially when courts are involved. Compare Jacobs (2006) (comparing complex US case law developments, particularly after *Unocal*); and Baum (2005) (arguing that German legislation since 2002 has ended up with the worst of all worlds: a mandatory bid rule as in the UK, which raises costs for the bidder, yet more liberal rules for incum-

further decisions along these lines. This might feed back into legislative reform in this area or related fields of corporate law (as indicated by Matsui's Chapter 5 on closely-held companies). Japanese courts have seen an upsurge in corporate law cases of many kinds since the 1990s,[21] creating more scope for further iterations of judicial innovation and legislative reform.[22]

Overall, this new direction in Milhaupt's work, starting to address why and how formal legal rules are created rather than just their impact on corporate behaviour, seems to go against some recent work by West. He argues that Japan's corporate law reforms, even since the 1990s, are driven by accelerating 'exogenous' shocks such as scandals, foreign competition and economic downturn. West contrasts this with 'endogenous' change, led by rent-seeking actors (notably lawyers and other lobbyists in the US) (West, 2001a). In Japan recently, however, accounts by Milhaupt and others instead suggest growing 'endogenous' competition – and perhaps even more broadly reasoned dialogue – among a growing array of state and even non-state actors.[23] West's more recent work with Pistor may be more suggestive especially for the current and foreseeable rounds of corporate law reform in Japan (Pistor et al., 2003a, 2003b). In particular, it does seem likely that the more 'enabling' Japanese corporate law continues to become, the more legal innovation will take place, and the greater the need will become for institutional innovation, including new law enforcement agents. Even under that model, however, the hybrid development under the 2002 reform makes it more doubtful that Japan (as a 'legal transplant country') will continue to reveal less innovative capacity (as measured by the authors' rate of legal change in corporate law and finance).

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bent management's takeover defences). However, Kozuka (2006) emphasises relative consistency in the Japanese case law dating back to the late 1980s, which developed the 'primary purpose rule' (described further in Chapter 8 by Kamiya and Ito). This was permissive of incumbent management in regard to issuing new shares, if it had fair reasons to raise capital, but was quite strict as to the price at which they were issued.

[21] See for example Takahashi and Sakamoto (2004); Nichibenren Homukenkyu Zaidan (2004).

[22] Broader comparative analogies could be made with new interactions between the two spheres in contemporary corporate governance in Australia (Corbett and Bottomley, 2004), and even more elaborate processes of 'reflexive harmonisation' in member states of the European Union adjusting their domestic takeover regimes in the shadow of a Directive finally enacted in 2004 (Zumbansen, 2004).

[23] See also Milhaupt (2005b, pp. 69–70) and Kanda (2006, pp. 31–41). It remains true that even Japan's rapidly growing commercial law firms (Nagashima and Zaloom, 2007) and the new fully profit-sharing Japanese/international law firm partnerships do not seem to be getting into this new policy-making game. However, perhaps that remains a unique feature of US law and society.

1.3 'The Gradual Transformation': Beyond Continuity – in Japan and Beyond

How should we assess then these very different answers to the question of whether there has been significant change in Japan and its corporate governance system? In particular, can we see already or expect soon the Americanisation of Japanese corporate governance law? As indicated above, one set of scholars would answer 'no', since change is not occurring either because Japan remains communitarian or because it is instead already profoundly individualistic. A second set would answer 'yes', either to a great extent (amounting to Americanisation) or to a modest extent (amounting, more precisely, to a more complex and gradual transformation). The last-mentioned conclusion is supported by most of the literature in English, as well as the much larger literature in Japanese (for example, Kanda, 2006). That is, Japan is experiencing significant but not overwhelming change in its system of corporate governance.

This conclusion is more than simply a middle-charting compromise. It also dovetails with the findings from a recent, multinational study on corporate governance, *Beyond Continuity: Institutional Change in Advanced Political Economies* (Streeck and Thelen, 2005a). Building on empirical studies in Japan, Germany, France, Hungary, the UK and the US, the editors argue that 'equating [1] instrumental with adaptive and reproductive *minor* change, and [2] *major* change with mostly exogenous disruption of continuity, makes excessively high demands on [3] 'real' change to be recognised as such, and tends to reduce most or all observable changes to adjustment for the purpose of stability' (Streeck and Thelen, 2005b, p. 8). They are impatient with theories of path dependence that tend either, as in work on varieties of capitalism, to imply [1] 'reproduction by adaptation', or – more rarely – [2] punctuated equilibria or 'breakdown and replacement' (Pempel, 1998, p. 3). Streeck and Thelen argue compellingly that theorists have not sufficiently recognised and conceptualised 'gradual transformation', the now much more widely observed combination of incremental change resulting in discontinuity (Table 2.1).

In my own matrix of prominent commentators on Japanese corporate governance, category [1] includes 'continuity' advocates like Haley, Jacoby and (to a lesser extent, recently) Dore. Category [2] comprises strong proponents of change like *The Economist*. Category [3], which perceives incremental changes that nonetheless add up to a significant transformation in Japanese corporate governance and society, includes myself, Milhaupt and West, Vogel (2005, 2006), and many other researchers.[24] Most believe that there will not

[24] See also for example Pudelko (2005b); Kanda (2006). On broader changes in

Table 2.1 'Gradual transformation' as discontinuous but incremental change

		Result of change	
		Continuity	Discontinuity
Process of change	Incremental	[1] Reproduction by adaptation	[3] Gradual transformation
	Abrupt	Survival and return	[2] Breakdown and replacement

Source: adapted from Streeck and Thelen (2005b, p. 9)

be any ready return to Japan's older model even as the economy regains momentum. Many across the spectrum – Jacoby, Dore, Patrick, even Ramseyer – further agree that considerable differences will remain among firms according to industry sectors and their broader institutional contexts.

Further, drawing from their cross-national study of liberalising advanced political economies, Streeck and Thelen (2005b, pp. 19–30) conceptualise five modes of gradual, transformative change. Many resonate with shifts in Japan since the 1990s (see also Aoki et al., 2007):

(1) *Displacement* This is where subordinate institutions (and related norms) slowly become more salient. In the Japanese context, displacement lies in the emergence of market principles over collaborative and 'coordinated' economic practices. Even if we accept Ramseyer's view that Japan has demonstrated strong market-driven forms of socio-economic ordering in the past, even after World War II, these were not the only forms. Either such forms were consciously or unconsciously downplayed or they struggled to displace other forms of socio-economic ordering due to economic, political, social or ideological costs (Teranishi, 2005; Vogel, 2006). One example is the 'learning by monitoring' mechanisms still at work in some areas of the automobile industry (Nottage and Wolff, 2005; Ahmadjian and Robbins, 2005). These mechanisms provide a vision and implementation of more

Japanese society, see another – aptly named – recent study: Kingston (2004). On the interface with politics, see Schoppa (2006); more specifically on labour law, see Inagami and Whittaker (2005). The term 'gradual transformation' seems to be adapted from the earlier 'Great Transformation' towards liberalised markets analysed by Polanyi (1944), who pointed out also how their more destructive effects could be constrained even in modern society. See Streeck and Thelen (2005b, p. 4).

trust-oriented business practices. They help explain why Japanese firms remain ambivalent about full-scale commitment to market mechanisms rooted more in a fundamental distrust of others.[25]

(2) *Layering* As introduced in Chapter 1, this is where new elements are added onto existing institutions, gradually changing the status and structure of the latter. A clear example of this in Japan is the superimposition of the Product Liability Law of 1994 onto the Civil Code (Nottage, 2004b). Another is the introduction of post-graduate 'law school' programs from 2004, which will have trickle-down effects on undergraduate legal education.[26] In corporate governance, examples of layering include: Japan's banks increasingly differentiating among corporate clients (Vogel, 2005); the small but significant uptake already of the optional 'committee'-style board system (discussed further in Lawley's Chapter 6); the addition of new stock markets for start-ups (TSE Mothers, and NASDAQ Japan – now called 'Hercules'); and the casualisation of the Japanese workforce (Sako, 2007; Wolff, Chapter 3 in this volume).

(3) *Drift* This is where institutions are not maintained despite external change. In Japan, drift is evidenced by the considerable delays in updating the regulatory regime for securing the safety of general consumer goods and other items (Nottage, 2007).

(4) *Conversion* This is where old institutions are deployed for new purposes or old structures are vested with new purposes. Examples of conversion in Japan include METI adopting the mantle of more liberal reformers within government (Elder, 2003); venture capital being incubated within corporate group subsidiaries (Vogel, 2006); and the contemporary reinvention of the Japanese labour movement's *shunto* (spring offensive) for pay rises each year (Sako, 2007).

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[25] This ambivalence, also among women in regard to proposed reforms over the last decade, is further highlighted in the review by Steven Vogel of Schoppa (2006) in (2007) *Journal of Japanese Studies* 32(2), p. 430. Vogel argues that to explain limited policy change in Japan, reinforcing or inducing socio-economic change, this factor needs to be added to Schoppa's emphasis on quite extensive but still costly 'exit' by firms (to overseas production networks) and by women (by marrying less or having fewer children).

[26] I concur with the assessment by Haley (2005a) that this initiative is unlikely to have much short-term impact. However, even here I concede some bright side, and potential for even more significant reform: Nottage (2006b).

(5) *Exhaustion* This involves institutions gradually withering away over time. Evidence of this in Japan lies in the attenuating commitment by large firms to guarantee lifelong tenure for core employees (discussed further in Wolff's Chapter 3).

In short, Japan is largely following other complex industrialised democracies – 're-regulating' while it 'de-regulates' (Nottage, 2005b). However, the Japanese case involves different mixtures of the main modes described above for achieving such incremental but transformative change. Overall, Japan appears to be undergoing a lesser degree of liberalisation than that taking place in Germany and especially France (Goyer, 2007).[27]

2. FIVE WAYS FORWARD

Five caveats are needed, however, before deciding whether Section 1.3's multi-modal pattern of transformation offers a more persuasive account of corporate governance in Japan. These caveats derive from methodological concerns raised in other comparative studies, and are also useful in carrying out studies of corporate governance beyond Japan. Specifically, when assessing change versus continuity, these caveats are that care should be taken in (i) selecting timeframes, (ii) choosing countries to compare, (iii) balancing black-letter law and broader socio-economic context, (iv) reflecting on (and disclosing) normative preferences, and (v) giving weight to processes as well as outcomes.

2.1 Timing

First, history matters. Analyses can turn on what economic conditions prevailed at the time of the study – whether in Japan or in the analyst's home country – and whether these conditions are linked to 'good' or 'bad' governance (Aronson, 2005). In the year 2001, for example, Japan was still reeling from unprecedented failures of banks and security houses in 1998, but the collapses of Enron, WorldCom and other major US companies were yet to come. The tendency, then, was to characterise Japanese corporate governance as 'bad' and US governance as 'good'. This was the context, for example, for the theory of strong convergence on the shareholder-driven model advanced by Hansmann and Kraakman (2001).[28] From 2002 onwards, however, the fall

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[27] But compare O'Sullivan (2005). Compare also Jackson (2005).

[28] Such tendencies are related to express or implied normative preferences, discussed further in Section 2.4 below.

of Enron and its aftermath led to scepticism about the benefits of the US approach (Hill, 2005). Hence, more commentators tended to perceive and acclaim ongoing divergences in governance styles, in Japan and elsewhere. Another problem is currency of data. As new theories are deployed to explain rapidly evolving realties, several empirical studies of corporate governance are problematic through their reliance on rather outdated data.[29]

Even if these challenges can be acknowledged and minimised, further problems arise in selecting time spans for comparisons. For example, aspects of US corporate governance have themselves changed considerably after 2002. In particular, the Sarbanes-Oxley Act (SOX) has allowed federal securities regulators to go beyond most market-oriented disclosure requirements, and impinge on traditionally state-based corporate law by imposing obligations as to board composition and other matters internal to the corporation (Cioffi, 2005). Thus, Figure 2.1 above would probably have looked rather different if the comparison had run only through to around 2000. The bell curve for the US would have been even further (right) towards the market end of the spectrum than 'US 2004'. This would suggest a growing divergence between the US and Japan, even as the latter also moves more slowly in that direction. Indeed, there might be further divergence in the next few years if, as Du Plessis et al. (2005) predict, there is a reaction against the more interventionist approach adopted by SOX, following findings that it did not prevent another round of preventable corporate collapses. Further complicating the picture, Puchniak (2007c) provides evidence indicating that corporate governance practices in the US have been partially 'Japanised' recently, for example through the increased monitoring role of creditors.

Figure 2.1 would have looked even more different if Jacoby (2005c, pp. 84–9) had compared Japan and the US between 1955 and 1980 rather than 1980 and 2004, since even US firms were much more organisation-oriented until the 1970s. As well as fewer differences in the distribution and means of firms in Japan and the US during that 'Golden Age', there would have been fewer shifts, supporting the 'strong-path-dependence' hypothesis rather than the 'weak-path-dependence' he tends to find between 1980 and 2004. Even if he had focused instead on the 1980s, he might have found more evidence of 'converging-divergences', with an increasing variety of firms in both countries

[29] Jacoby's empirical research appears to date back to around 2001. That at least was the year in which he conducted his mail survey of listed Japanese and US firms. It is unclear when exactly the interviews of several companies in similar industry sectors in both countries were carried out. A similar temporal lag is found in Learmount (2002, p. 41), whose fieldwork on 14 Japanese firms was principally 'carried out in 1998–99, with some follow-up visits in 2000'; and in Inagami and Whittaker (2005). Interviews by Hasegawa (2005) for his eight case studies were conducted in September 1999.

and even a shift of the means towards each other, as some firms in the US adopted or adapted some Japanese-style management techniques. Conversely, Jacoby (2005c, pp. 19–20) would have found less support for the 'national-model' hypothesis, namely that only Japan is moving towards more market-oriented practices.

Even if we focus on recent history, say 1980–2004, this may not necessarily predict where Japan or the US will head in the next few decades. As Jacoby concedes, both countries now stand at a crossroads, although Japan may be under more pressure despite its institutions remaining less open to normative and political perturbations (Jacoby, 2005c, pp. 163–73). Looking back over a broader historical period, say 1980–2030, we may well conclude that Japan converged somewhat on the US particularly over the late 1990s, only to diverge further after 2005 as relative economic performance picked up, even without any more shifts in the US towards market-oriented solutions. Thus, we would have to acknowledge considerable *change*, but not necessarily consistent *convergence*.[30]

On the other hand, extending the historical frame of reference has encouraged bolder commentators to detect and advocate broader worldwide convergence towards shareholder primacy in corporate governance (Hansmann and Kraakman, 2001) or, more generally, a modern liberal 'horizontal society' (Friedman, 1999). Even Hall and Soskice (2001), proponents of 'varieties of capitalism' theory that otherwise predicts ongoing divergences, have conceded that more 'coordinated market economies' (CMEs) like Japan and Germany remain at risk of a one-way slide towards Anglo-American 'liberal market economies' (LMEs) if and when trust relationships unravel. However, as mentioned above (Section 1.3), outright displacement does not seem to occur so straightforwardly. More generally, Tanase contends that the more we push for modern liberal law and society, the greater the resistance encountered as inherent contradictions emerge and community reasserts itself (Nottage, 2006c). Yet this raises the question of when such reactions will begin to set in, which may not be until a country like Japan has moved towards highly liberalised markets and a considerable dose of US-style 'adversarial legalism' (compare Kagan, 2001). Thus, even if change does not occur uniformly, we may need to acknowledge more potential for convergence as we expand the temporal frame of reference.

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[30] See also generally Du Plessis (2004). The studies by Milhaupt and West, introduced in Section 1.2.2 above, may also tend to stress convergence due to their timing. Most were completed before the Japanese economy and corporate performance began to pick up again from 2002.

2.2 Countries to Compare

Second, we should be careful about our points of comparison, especially when discussing convergence. In particular, it is risky or unproductive just to select two, such as Japan and the US, as this can lead to 'an undue emphasis on differences' (Aronson, 2005, p. 43). This is a broader problem in all comparative law research. Adding a third jurisdiction can uncover some important similarities between the two others, compared with this new reference point.[31] Adding Germany – common in the comparative corporate governance debate given its own post-war economic performance followed by more recent malaise – suggests US exceptionalism. However, most commentators see a greater shift towards the US model, driven partly by the economic imperatives of EU market liberalisation.[32] Germany is certainly not becoming the US (Baum, 2005; Cioffi, 2005) and, as just mentioned, some ruptures have appeared in the US model itself particularly after the Enron debacle. Nonetheless, if we were to add Germany to the spectrum in Figure 2.1, we would probably have to interpose similarly shaped bell curves between the pairs for Japan and the US. Moreover, Germany's mean shift for 1980–2004 would probably be greater than Japan's ('x' in Figure 2.1). Comparing Germany in this fashion would mean 'directional convergence' (Jacoby, 2005c, p. 12) for both Japan and Germany, towards the US model. Yet there would be less 'pull' on Japan and stronger path dependence. This would be an interesting result because we might fairly say that Japan is converging less, and also speculate that Germany could become a (hybridised) 'national-model' instead of the US.

It is also tempting to expand the countries compared. This has been characteristic of the 'second generation' of comparative corporate governance scholarship, after a first generation that simply investigated key areas of US concern in individual countries (Denis and McConnell, 2005). Much broader cross-national research into corporate governance is also becoming popular among political scientists (for example, Gourevitch and Shinn, 2005). As explained in Section 2.5 below, however, there is certainly a risk in all such studies of producing 'very broad and somewhat superficial conclusions, for example, on issues such as the protection of minority investors, without giving any consideration to the difficult process of adapting foreign law concepts and corporate governance institutions to fit into one's own system' (Aronson, 2005, p. 43).

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[31] See for example Nottage (2002), arguing that the main divide is between Anglo-New Zealand law on the one hand, and Japanese and US law on the other.

[32] See for example Pudelko (2005a). He too stresses the importance of timing: changes in human resource management practices in Japan began two decades ago, although they have accelerated during the prolonged recession.

2.3 Black-letter Law (Changes) versus Socio-economic Context (Continuities)

Third, analysts and their audiences must be aware that in comparative legal studies there is a tendency to find extensive change and hence much convergence when focusing on narrower, more formal 'black-letter law'. By contrast, little change and instead divergence tends to be the conclusion when looking at law in broad context (Ginsburg et al., 2001; Nottage, 2004a). There is no necessary correlation between these dyads. A good example of this is a study by West (2001a) who demonstrates how the *statutory* provisions added to the Japanese Commercial Code from Illinois law during the Occupation in 1950 have actually *diverged* from their source. Nonetheless, comparative corporate governance research is becoming ever broader in scope, encompassing other areas of business regulation (Winkler, 2004). The broadening makes it important to guard against too readily concluding that regimes overall are – and will remain – fundamentally divergent and resistant to change. That may be true along some dimensions, but not along all.

2.4 Normative Preferences

Fourth, in trying to become more reflective about the purposes of comparative research, we need to be more open about underlying normative influences impacting on empirical observations. The field of comparative corporate governance expanded from the 1980s, just as culturalist approaches started to lose popularity compared with the economic analysis of law. In reaction to the more avowedly normative stance of culturalist accounts, the economic analysis of corporate governance has tended to stress a purely empirical, normative-free agenda. However, just as in other areas of economics (Ferraro et al., 2005), hidden normative agendas and the power of rhetoric are readily apparent. Thus, Ramseyer goes further than simply submitting that Japan has always had a competitive market economy and concomitant legal system, populated by narrowly rational economic actors. He seems to imply that it *should* have these features, and thus be thoroughly deregulated if there happen to exist any anti-competitive remnants.[33]

By contrast, despite some of his own protestations to the contrary, Haley seems to want Japan to retain its perceived communitarian core and related

[33] See Nottage (2005b). Such a disguised normative agenda – wanting empirical studies to prove that markets always clear, but otherwise to deregulate to force them to do so – is also very much the approach of the (first-generation) Chicago School of (Law and) Economics: Freedman and Nottage (2006).

broader stakeholder approach to corporate governance (Haley, 2005a).[34] Thus, he both perceives and acclaims instead a more conventional regulatory paradigm. Dore (2005b, 2007) increasingly concedes that significant change is underway, but still apparently wants Japan to use its remaining social capital to resist extreme shareholder-oriented corporate governance. The Editor of *The Economist*, by contrast, wants both to uncover and to complete the unravelling of stakeholders and community, in favour of the liberal models of economic and social ordering persistently trumpeted by the journal.[35] 'Gradual transformation' theorists like myself may be more well-disposed towards some features of Japanese law and society – sometimes communitarian, sometimes radically individualist. We may hope that Japan can recombine them in optimal ways to meet evolving social needs and expectations. This may colour my perception that reregulation is more pervasive in Japan than outright deregulation (Nottage, 2005b). All this is not to say that we should abandon the search for empirical groundings for our normative inclinations. Instead, we should be more explicit about the latter, and how they may frame our empirical inquiries and conclusions.

2.5 Processes, not just Outcomes

Finally, one particularly promising way to conduct comparative corporate governance research is to move away from analysing and predicting specific *outcomes*, and instead focus on *processes* impacting on Japan's evolving corporate governance regime. As well as inviting us to rethink how we assess change versus continuity, a process-oriented research agenda may encourage the application of a broader range of methodologies to answer new questions. Studies should really involve sustained qualitative research as well as quantitative methods (see, for example, Inagami and Whittaker, 2005; Vogel, 2006). They should be cautious about relying so much on the regression analyses that became almost de rigueur in analyses of commercial regulation from the 1990s. These deal in aggregates, so cross-country analyses may indicate statistical support for the proposed model or theory, despite results for particular countries (including important economies like Japan's) not actually according with the theory. Even when focusing on just one country, quantitative analysis in Japan is impeded by a relative paucity of good data sets for social scientists (Brinton, 2003). Already, we see salutary signs of impatience with applications of econometrics alone precisely in the field of comparative corporate gover-

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[34] Indeed, he wants more such elements in the US: see also Haley (1999).

[35] See also already Emmott (1991); and, urging Japan to tow the hawkish American line nowadays even on foreign policy, Emmott (2004).

nance (West, 2002b), and hence experiments in combined methods for other socio-legal studies of Japan (West, 2002a).[36]

In particular, Gourevitch and Shinn develop an explanatory model that is amenable to both multi-country quantitative analysis and country-specific case studies (Gourevitch and Shinn, 2005). Their model draws from correlations observed among data sets and some limited regression analysis and includes the following variables:

a. 'politics' – an independent variable comprising 'preferences' of different interest groups towards governance regimes, combined with political 'institutions' such as constitutional frameworks and political parties generating majoritarian versus compromise approaches; leading to
b. 'policies' – an intervening variable, reflected in 'minority shareholder protections' or MSPs; and 'degrees of coordination', features of LMEs versus CMEs (Hall and Soskice, 2001); causing
c. 'corporate governance' variations – the dependent variable, measured by diffuse shareholdings characteristic of the Anglo-American shareholder-primacy model versus 'blockholding' or concentrated shareholdings characteristic of stakeholder systems.

Regarding (a), political preferences, Gourevitch and Shinn deduce three main categories of tensions and predict different corporate governance outcomes accordingly (see Table 2.2). They argue that these more fine-grained coalitions and tensions better explain differences among countries as well as their continuities or changes.[37] For the countries added in square brackets in Table 2.2, Gourevitch and Shinn then provide an 'analytic narrative' or more qualitative explanation. This is probably necessary as their model gains in complexity to better fit messy realities. For example, Germany is seen as representing a 'corporatist compromise', gradually unfolding towards a 'transparency' coalition as workers (W) switch allegiance from managers (M) to owners (O) in an attempt to maintain employment in a stagnating economy. By contrast, Gourevitch and Shinn (2005, p. 167) conclude that:

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[36] See also for example Upham (2005). He exposes the strengths and weaknesses of both Ramseyer's quantitative approach to the vexed issue of whether and why Japanese judges are truly independent in politically charged cases, and Haley's more historical and institutional approach.

[37] Compare this with studies such as those by Roe (2003) which focus on class conflict as a major determinant of 'path-dependent' continuities in corporate governance regimes.

Table 2.2 Multi-country political coalitions and overall corporate governance outcomes

Coalitional lineup	Winner	Coalition label [country case studies]	Predicted outcome
Pair A: class conflict			
Owners (O) + managers (M) v. workers (W)	O + M	Investor [Korea]	Diffusion
O + M v. W	W	Labour [Sweden]	Blockholding
Pair B: sectoral conflict			
O v. M + W	M + W	Corporatist compromise [Japan, Germany until recently]	Blockholding
O v. M + W	O	Oligarchy [Russia]	Blockholding
Pair C: property and voice			
O + W v. M	O + W	Transparency [Chile]	Diffusion
O + W v. M	M	Managerialism [US, France]	Diffusion

Source: adapted from Gourevitch and Shinn (2005, p. 23)

> Japan is a case of a resilient corporatist compromise, grounded in a post-World War II historic compromise between managers and workers that is sustained by consensual political institutions. Since World War II there have been no broad changes in preferences towards governance, and only marginal changes in political institutions (a partial modification of electoral rules in 1996 [sic: 1994]). As predicted by the corporatist compromise model, Japanese MSPs remain relatively low, although concentration [of shareholdings] is also low. This low level of concentration also has historical roots, when Japan's blockholding *zaibatsu* families were wiped out by the US Occupation.

One problem with their model as applied more specifically to Japan is the disjunction they acknowledge between diffuse shareholdings (characteristic of US-style corporate governance) versus coordinated policies and consensus-based politics. Even so, because quantitative analysis deals in aggregates, overall the model can survive such anomalies provided other countries 'fit' better. Thus, especially if we are interested in one country like Japan, we need

to look carefully at more qualitative analysis. Shareholder diffusion has been generally seen as much lower than estimated by Gourevitch and Shinn (2005, pp. 18–19), as indeed they concede, even though stable and cross-shareholdings have unwound considerably since the late 1990s (Okabe, 2002). In this regard, the role of 'main banks' also still needs to be taken into account (as Puchniak's Chapter 4 emphasises), even though this may be difficult to separate out in quantitative terms. Thus, Japanese corporate governance becomes less of an anomaly for their model, because corporatist politics, weak MSPs and CME indicators match up with greater de facto blockholding. However, an alternative recalibration in support of their model seems more plausible. Drawing on black-letter law and less readily quantified information, there appear to be more US-style features both in the levels of MSPs and LME indicators related to 'policies', and in the complexities of 'politics' especially since the 1990s. Yet this demands an acknowledgement of more 'gradual transformation' or even some convergence on the US, or at least a new 'transparency coalition' for Japan, as Gourevitch and Shinn find to be emerging in Germany.[38]

Overall, especially when quantitative data are supplemented by qualitative data and accurate analysis of the legal rules and their enforcement, the model they propose is a very promising recent approach highlighting especially the processes generating the rules of the game in corporate governance. Complementing that emphasis, Milhaupt and West mainly focus on how those rules then feed back to impact on corporate behaviour. In analysing such processes, though, we may need to develop even more sophisticated models of contemporary politics and policy-making (as Pokarier attempts in Chapter 9 of this volume). Recall from Section 1.2.2 the suggestion by Gilson and Milhaupt (2005) that making committee-style boards optional rather than mandatory was due to a compromise among Japan's ministries and associated interest groups. Such views find parallels with the 'public choice' explanation for what Rubin (2005) analyses as 'legislative failure'. On this hypothesis, more tightly organised groups will tend to hijack the policy-making process in the pursuit of narrow self-interest.

Generally, however, public choice theory has faced powerful criticism on empirical grounds. Studies have shown how more diffuse groups have

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[38] Regarding 'policies', Nottage (2001) queries already the ready characterisation of Japan as a CME rather than an LME, as well as noting quite strong MSPs at least 'on the books' in Japan. More elements of an LME also no doubt explain at least some of the results from the studies by Ramseyer. Regarding 'preferences', Gourevitch and Shinn (2005, p. 9) stress that a shift away from pay-as-you-go public-sector pension schemes is a 'substantial driver of new coalitional possibilities', and agree with Dore (2000a) that there have been few changes yet in this area in Japan. Yet they may have over-estimated this factor, as their account acknowledges few changes in this area in Germany as well.

managed to coalesce to become effective actors in the political process. Legislators (and their bureaucratic agents) are often motivated by broader concerns such as ideology and the desire for respect from their peers (Rubin, 2005, pp. 584–7). Rubin argues that 'special interests' theory, emphasising social elites' ability to dominate politics, is more convincing because it allows for the possibility of legislative success as well as failure. However, it ties such success to restricting political influence over policy-makers in favour of neutral and mostly bureaucratic expertise. Therefore, it remains too narrow and deterministic in emphasising the power of social groups and structures. 'Pluralism' is a more recent variant of this theory, although it sees legislative success – as well as failure – as resulting from a political process itself strongly influencing the formation of groups that struggle to dominate it. 'Deliberative democracy' theory takes this notion of politics a step further as an independent social process generating its own dynamics and alliances. Deliberative democracy suggests that politics may also generate individual or group commitments (rather than just representing them), potentially achieving more legislative success by allowing commitments to be redefined through rational public debate.

All four theories, however, tend to assume a clear distinction between good public policy and the political process. Rubin (2005) views this as increasingly untenable, descriptively and normatively. He suggests that we focus more directly on good or bad processes coupling both policy-making and politics. In particular, Rubin agrees with empirical studies suggesting that bad processes can be associated with 'conceptual failure' – generating legislation excessively framed by pre-conceived ideas derived, for instance, from prior legal concepts (for example, Morag-Levine, 2003). Descriptively, and indeed normatively, this approach has its attractions for Japan; but so do theories of pluralism and, more especially, deliberative democracy. Certainly, compared with special interests and public choice theories, they seem a more promising way forward to understanding distinct shifts in Japan's policy-making processes particularly since the late 1990s.[39]

To further demonstrate the usefulness of moving away from an obsession with outcomes, even if these appear more measurable, consider Japan's Lower House election on 11 September 2005. Some might conclude that politics has not changed in Japan since the 1990s, due to the conservative LDP's huge victory or, at least, the then Prime Minister Koizumi's campaign agenda

[39] See for example Kozuka and Nottage (2008). See also the more complex pictures revealed in Drysdale and Amyx (2003), Schwartz and Pharr (2003), and Hook (2005). However, Stockwin (2007) emphasises the more authoritarian tendencies of both Koizumi (favouring free markets) and his shortlived successor, Shintaro Abe (more interventionist and nationalist).

centring overwhelmingly on reforms to the postal system.[40] But others might see the glass to be half full (changing), rather than half empty (unchanged), or even to be almost full (radically changed). One way out of this impasse is instead to focus on the process or events leading up to this election. Then it appears much clearer that Japanese politics has changed considerably. Novel elements include the dissolution of the Lower House to go back directly to the citizenry on a key policy issue; the abandoning of anti-reform LDP politicians in favour of high-profile outsiders (dubbed 'assassin' candidates); and even the LDP's candidates' 'cool biz' style of campaigning in open-necked shirts.

Mulgan, therefore, seems to have been too quick to predict 'Koizumi's failed revolution' (Mulgan, 2002). Her more recent analysis of agricultural policy provides 'a litmus test of political and policy change', since it exemplifies traditional political economy centred on closely aligned LDP politicians, officials and farmers. After examining 'changes to electoral, bureaucratic and policymaking systems, and underlying demographic, political, social and economic trends', Mulgan concludes that even Japanese agricultural politics is in a state of transition (Mulgan, 2005). However, McCormack goes too far the other way in describing the latest election as part of Koizumi's plan for 'the substitution of a Hayekian, neo-liberal, American way for the Keynesian *doken kokka* [construction state] redistributive, egalitarian way' (McCormack, 2005). Instead, these political outcomes again seem to represent another gradual transformation.

Perhaps more importantly, and reinforcing this sense of important shifts, the Koizumi administration initiated many broader 'procedural changes in the policymaking *process*' (Machidori, 2005, emphasis added). Koizumi's new brand of populist politics also involved moving power away from the LDP's Policy Affairs Research Council (PARC) and into the Cabinet Office; electing ministers outside the traditional LDP factions; and centralising election funding (Amyx, 2005; Cook, 2006). Although new processes such as these can still result in outcomes that seem to reinstate the status quo, the very fact that the processes are new is an important indication of change.

3. CONCLUSIONS

Ultimately, nuanced analyses of corporate governance changes in Japan – which strike at the heart of broader developments in Japanese capitalism and socio-legal ordering – must go beyond how the rules of the game influence the

[40] See, for example, Haley (2005a), 'Japan's election' 376 (8444) *The Economist*, 15 September 2005, p. 12.

players. They must also consider why and how the players redefine those rules. In other words, we must examine more closely 'patterns of policy reform', as well as 'patterns of corporate adjustment' (Vogel, 2005, pp. 153–62). A rich theoretical and empirical literature, increasingly drawing on both quantitative and qualitative analysis, shows how firms and social actors in Japan and elsewhere do more than respond to regulatory environments. They also attempt to reshape them, without necessarily capturing them as public choice theory predicts. An example is the growth of unsecured consumer credit since the early 1990s, resulting in recent re-regulation (Kozuka and Nottage, 2007, 2008).[41] Studies along these lines, focusing on processes and more complex feedback loops, seem likely to reveal further significant transformations in Japanese corporate and public governance. Consequently, they explain better the modes of change and considerable diversity of outcomes currently in Japan.

Moves in this direction, moreover, call for more interdisciplinary dialogue. Those engaged in debates framed primarily by law and economics can benefit from greater engagement with the work of sociologists and political scientists, and vice versa. Social scientists may also need to take more seriously the inner logic of legal discourse, understanding how courts develop case law (as in the field of hostile takeovers, elaborated by Kamiya and Ito in Chapter 8) in direct or indirect dialogue with legislators or bureaucrats. Such interdisciplinarity also characterises new tendencies in broader studies of comparative capitalism (Zumbansen, 2007). In ongoing theory-building and applications, particularly in comparative corporate governance, further insights can also be drawn from comparative law methodology. These include closer attention to timing and timeframes for comparisons, selection of countries, balancing black-letter law and broader socio-economic context, and acknowledging normative preferences.

41 Compare generally Gunningham et al. (2003); Howard-Grenville (2005).

3. The death of lifelong employment in Japan?

Leon Wolff

Lifelong employment in Japan is more trope than literal fact. As a synecdoche, it encapsulates Japan's system of industrial relations. As a metonym, it epitomises the employee-oriented communitarian firm (Abe and Shimizutani, 2007, p. 347). As a metaphor, it represents Japan's distinctive form of stakeholder capitalism (Dore, 1993). Yet none of these tropes holds as a truth. Lifelong employment does *not* signify the dominant form of employment in Japan. It does *not* privilege employees' interests over business concerns. And it does *not* constitute a benign, kinder form of capitalism compared with the market-based model.

If there is one trope that best describes the institution of lifelong employment in Japan, it is irony. As this chapter will show, lifelong employment is not an *institution* at all. If anything, it applies to less than 20 per cent of the working population, mostly male workers in large companies or public institutions – and, even then, only for a portion of their working lives (Hiwatari, 1999, p. 275; Marshall, 2005, pp. 103–4). Nor, to the extent that it does exist, is its exclusive concern with guaranteeing lifetime job security. Rather, both in practice and in law (Araki, 2000, 2005, 2007; Yamakawa, 2001), it enshrines 'flexicurity' (Wilthagen and Tros, 2004) – a combination of *security* of employment and *flexibility* of working practices. Nor is it innately 'Japanese'. It is neither a cultural form of co-operative, communitarian capitalism (for example, Jacoby, 2005a, 2005b, 2005c) nor an a priori institutional pillar of an alternative economic design to self-equilibrating markets (compare Aoki, 1988; O'Connor, 1993). Instead, it is a politically invented tradition, initially created to ensure industrial peace in post-war Japan and subsequently preserved to support Japan's ensuing regime of accumulation (Coates, 2000, pp. 133–4).

All this, of course, complicates what should be a simple research question: is lifelong employment a dying institution? Certainly, this has become a popular question among legal scholars (for example, Araki, 2007), political scientists (for example, Hong, 2004; Kwon, 2004) and economists (for example, Dore, 2000b). With Japan mired in an economic slump during the 1990s and

into the early 2000s, some commentators were predicting the 'death' or de-institutionalisation of lifelong employment (for example, Ahmadjian and Robinson, 2001). Others, however, were insisting that the institution remains, and will remain, largely in place (for example, Konzelmann, 2005). A key reason why this debate has so animated such a diverse group of scholars is that the tropes employed to describe lifelong employment weave a much larger – and more gripping – narrative about the fate of Japanese corporate governance and capitalist style. Lifelong employment is not simply a story about an isolated employment practice; it is an allegory of the viability of the 'J-firm' (Abe and Shimizutani, 2007; Aoki, 1988) and the durability of Japan's model of stakeholder capitalism (Boyer, 2001; Boyer and Yamada, 2000a, 2000b). This significantly raises the stakes. If lifelong employment is dying, does this signal the end of Japanese-style stakeholder capitalism and the triumph of Western-style shareholder primacy? Or does the Japanese model still endure as a 'variety' of capitalism? Put differently, are there multiple means to sustain good economic performance, or is there only 'one best set of policy prescriptions'? (Marsden, 2004, p. 152.)

Stripped of all its literary embellishments, can lifelong employment serve as a useful case study to address these questions? Some might argue that, as an abused metaphor, lifelong employment is an imperfect guide to Japan's system of corporate governance and an unreliable gauge of the pace and direction of institutional change in Japan since the 1990s. This chapter does not accept this view. If anything, unpacking the defining traits of lifelong employment should afford even more penetrating insights into the changes unfolding in Japanese industrial relations, corporate governance, law and the economy. This is because a more nuanced understanding of lifelong employment allows us to reframe the big questions we ask. Then we can see a different 'bigger picture' of Japan. Thus, this chapter argues that recent developments in employment practices, such as rising unemployment and the casualisation of the workforce, do not support conclusions of a convergence to a market-based, dismissal-at-will system of employment, nor the persistence of Japan-specific institutions and norms of labour relations. Instead, a transformation is taking place – one based on the *intensification* of existing regulatory modes of 'flexicurity'. This intensification might very well lead to a crisis in the labour–management nexus in Japan, perhaps even its wholesale overthrow. Yet, so far, no new political compromise has been struck (Boyer and Juillard, 2000).

These conclusions open up a number of provocative theoretical challenges. First, since cultural and neo-institutional theories fail to explain the developments in industrial relations in Japan, we need new theories for understanding dynamic change in Japanese legal and economic institutions. Second, since lifelong employment is a governance technique that is not

universal, ahistorical or neutral, we need new theories that take seriously the heterogeneous, transient and political dimensions of corporate governance. Third, since Japanese capitalism is a regime of accumulation like any other yet with its own defined set of strategic choices, we need new analytical tools for interpreting the roots of the Japanese political economy (not just its institutional manifestations) and for reaching an informed assessment of its normative value (rather than calibrating judgments to its fluctuating business cycles).

This chapter is structured as follows. Section 1 defines lifelong employment. It explains how lifelong employment functions within the broader scheme of industrial relations in Japan and as a governance technique in Japanese firms. Section 2 then explores the different theories advanced to account for the existence of lifelong employment. These different accounts contain hints as to how lifelong employment might potentially 'die'. For example, for those who believe that lifelong employment represents disequilibria in the market place, deregulation of labour laws should correct this problem and bring an end to the practice (Miwa and Ramseyer, 2002). For those who submit that lifelong employment is a cultural practice, social change and globalisation should lead to its gradual erosion (Jackson and Miyajima, 2007, pp. 5–6). And for those who claim that lifelong employment is an institution that interlocks with other complementary institutions of corporate governance (such as the 'main bank' system described in Puchniak's Chapter 4, *keiretsu* cross-shareholdings and insider boards), change or reform to one institution will have a dynamic effect on all the others (for example, Aoki, 2007; Sako, 2007; Streeck and Thelen, 2005b, pp. 19–30; see also Nottage's Chapter 2 in this volume). However, this section submits that lifelong employment is a political compromise between labour and management in the post-war period. Accordingly, it will only be dismantled once its inherent contradictions force a new compromise to be negotiated (Boyer, 2001; Boyer and Juillard, 2000).

Section 3 goes on to analyse the results of a range of empirical studies on lifelong employment. This section argues that the empirical data do not support conclusions of a convergence to a market-based, at-will system of employment, nor the persistence of Japan-specific institutions and norms of employee welfare. Instead, a transformation is taking place – one based on the intensification of existing measures of flexicurity. Section 4 buttresses this conclusion by describing how Japanese labour law regulates flexicurity, and how it has sanctioned its recent intensification. Section 5 then offers some brief observations on the ramifications of this analysis for understanding corporate governance and capitalism, both in Japan and in a broader theoretical and comparative context.

1. WHAT IS LIFELONG EMPLOYMENT?

1.1 Romanticism

Lifelong employment is frequently described in bullish terms. Heralded as one of the 'three sacred treasures' in Japanese industrial relations, along with seniority-based wages and enterprise unions (Hiwatari, 1999, p. 275), lifelong employment is regarded as the centrepiece of Japan's distinctive 'Employment System' (Coates, 2000, p. 127; Boyer and Yamada, 2000b, p. 14) and a core promise underscoring Japan's 'wage–labour nexus' (Boyer and Juillard, 2000). Under this practice, employees enter a firm immediately after graduation and remain with the same firm as permanent employees until retirement age. They receive in-house skills training, secure promotions and wage increments in line with their length of service, and enjoy welfare provisions from their employers. They derive social prestige and self-esteem from the firm to which they choose to attach themselves (Ahmadjian and Robinson, 2001, pp. 623–4; Blanpain et al., 2007, pp. 526–7; McAlinn, 2007, pp. 403–7).

Lifelong employment, in short, suggests a job for life. As a result, mid-career hires and resignations are rare (Dore, 1993, p. 68). To be sure, lifetime job security never forms part of any explicit contractual promise. Rather, it is an 'unwritten . . . guarantee' (Dore, 2000b, p. 107), a 'social norm' (Jackson, 2007, p. 282) or a 'moral imperative' (Ahmadjian and Robinson, 2001, p. 624). Nor is it mandated under Japanese corporate law. Indeed, as Araki (2005, p. 26) observes, Japanese corporate law enshrines the principle of shareholder primacy just as unambiguously as Anglo-American law:

> Japanese corporate law presupposes that a corporation is [the] shareholder's property and the role of management is to maximize the interests of shareholders. Unlike [the] German co-determination law which opens the supervisory board to employee representatives, Japanese law does not give employees or their representatives any status as a constituent of the corporation. . . . Thus, ostensibly Japanese law resembles more the Anglo-Saxon market-oriented model.

As a corporate practice that privileges employee's interests over shareholder returns, lifelong employment is said to exemplify Japan's kinder, more benign – and normatively superior – brand of capitalism. It represents 'stakeholder governance' (Jacoby, 2005b), a 'proletarian paradise' (Coates, 2000, p. 131), the 'communitarian firm' (Inagami and Whittaker, 2005) or 'human capitalism' (Ozaki, 1991). The firm is a family or a community. Employers and employees enjoy a relationship of trust and goodwill. In return for security, training and welfare provisions, employees pledge their hard work and their loyalty. The relational ties between employer and employee bring specific economic benefits, too. The long-term attachments make it worth-

while for firms to invest in the technical training of their workforce in a planned and coordinated way. Early-career employees can be rotated throughout the different divisions within the firm or enterprise group to acquire a broad set of company-specific skills (Haley, 2005b). When companies decide to embark on new business strategies requiring new skills, they have the incentive to retrain their mid-career personnel (Lazonick, 1992, p. 144). Employees, too, are more likely to be industrious, to cooperate with their colleagues, and to limit wage demands to reasonable levels (Coates, 2000, pp. 127–8).

When expressed in such broad descriptive and normative terms, lifelong employment signifies the distinctiveness of Japan's system of corporate governance, especially when compared with the US version. As Konzelmann (2005, pp. 593–4) puts it:

> Traditionally, Japanese firms have been 'organisation oriented' while American firms have been more 'market oriented'. This is reflected in the dominant features of corporate governance and work organisation, where despite movement towards the American model, the Japanese system of *stakeholder*-oriented corporate governance and its view of labour as a productive resource continues to stand in sharp contrast to the American *shareholder*-based system and view that labour is a factor of production with a *cost* to be minimised.

Dore agrees, drawing on the imagery of the clan to differentiate the Japanese firm from its American cousin. The Japanese company, he writes, is a 'transcendental entity'; managers are more 'elders of an enterprise community' than 'the agents of shareholder principals'; and employees have a 'relationship with their firm comparable to a soldier's sense of regimental loyalty'. This is a 'long way' from the view of the firm as a nexus of contracts (Dore, 2000b, p. 107). Even those who describe Japanese corporate governance in more prosaic language see lifelong employment as evidence of 'collective capitalism' rather than US-style 'proprietary capitalism' (for example, Jacoby, 2005b; Lazonick, 1992). These ideas about lifelong employment as a signifier of Japanese difference shape judgments about the economic merits of the system. During the height of Japan's economic might, for example, lifelong employment – and Japan's broader model of stakeholder capitalism of which it forms part – was trumpeted as the secret of Japan's success, a worthy alternative to the liberal market economy and a model worthy of wider emulation. During the more recent downturn, however, it was branded as a drag on labour mobility and an economically inefficient anachronism (Ahmadjian and Robinson, 2001, p. 624; Boyer and Yamada, 2000, p. 3).

This sets the scene for the debate about the fate of lifelong employment as a governance measure. Since the 1990s, permanent employment has come under sustained economic and social pressure. The end of four decades of economic growth – marked by the fall of the stock market and the bursting of

the asset bubble – saw Japanese businesses weighed down by a surplus of labour in the face of increased international competition, reduced sales, mounting bad debts and a stronger yen (Ahmadjian and Robinson, 2001, pp. 624–5). The ageing of the population was also contributing to a glut of workers in the higher salary ranges. Social values about work – especially among women and the young – began to change (Mouer and Kawanishi, 2005, p. 258):

> They are reflected in the establishment of venture capital firms, in the spread of the *furiitaa*[1] and the parasitic singles lifestyle (which is accompanied by the postponement of marriage and children), in the free-agent schemes for individual employees, in the extension of the mandatory retirement age, in the high turnover of those in their first job following graduation, in the 'slow life movement,' and in the general romanticism associated with alternative lifestyles.

From all this, some predict the 'death' of lifelong employment and a shift towards a more US-style market-based approach to corporate governance and employment relations.

1.2 Robustness

But a debate on such terms depends on the robustness of underlying definitions. To what extent are the impressions about lifelong employment, described above, truly representative of industrial relations in Japan? Do they properly depict the precise parameters of lifelong employment as practised in Japanese companies? Alternatively, do they caricature the institution and thereby have a distorting effect on debates about Japanese corporate governance, by over-stylising the facts and over-emphasising central tendencies (Jacoby, 2005c, p. 619)?

Certainly, the empirical evidence raises doubts about the reliability of general depictions of lifelong employment. Foremost among these is the myth of ubiquity – that lifelong employment constitutes a 'system' or an 'institution' (Hiwatari, 1999, p. 275; Marshall, 2005, pp. 103–4; Ono, 2007). Long-term security is usually reserved for a core workforce of mostly male workers in large companies or major institutions such as government ministries and agencies, schools and banks. Yet as Matsui describes in Chapter 5 of this book, small and medium enterprises (SMEs) – not large, public companies – dominate the corporate sector and employ most of the Japanese workforce. Thus,

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[1] *Furiitaa* refers to freelance workers. It is a neologism comprising 'free' and '*arubaito*' (a Japanese term for part-time work, derived from '*Arbeit*', the generic German word for work).

small-sized companies with less than 100 million yen of paid-in capital account for 98.4 per cent of all stock corporations in Japan (NTA, 2005). Smaller firms with less than 100 workers employ 71.8 per cent of the entire labour force compared with 10 per cent for major companies with over 5,000 employees (Mouer and Kawanishi, 2005, p. 119). And 85.6 per cent of all Japanese businesses employ less than 20 regular employees (MIAC, 2004b). Lifelong employment, then, is restricted to a very small proportion of existing firms.

Not surprisingly, therefore, lifelong employment only applies to a minority of workers. Applying different measures of lifelong employment, Ono (2007, p. 33) estimates the proportion of Japanese workers who enjoy lifetime job security to be around 20 per cent:

> (i) The ex-ante measure of the core workforce, which assumes that lifetime employment is limited to male standard workers in large firms (≥ 500) and in government, is 19 per cent; (ii) The proportion of lifetime workers, defined as those in the age group 50–54 who have never left their employers since school graduation, is 18 per cent; (iii) The probability of surviving job separations for 30 years is 20 per cent; and (iv) The proportion of workers in the age group 50 to 54 who have never experienced job separation is 22 per cent.

The remaining 80 per cent are either full-time workers in smaller enterprises with lower wages and poorer working conditions or 'atypical' workers. The latter include part-time employees on fixed-term contracts, casual workers (*arubaito*) without any contractual protections, freelance workers (*furiitaa*), and temporary workers dispatched by secondment agencies.

Lifelong employment also disproportionately benefits men over women (Lazonick, 1992, p. 144). Evidence of gender stratification is clear from data on the share of workers in certain categories of tenure. Based on wage census figures in 2000, women are over-represented in the category of less than one year and under-represented in the longer-term categories. Thus, 51.0 per cent of men enjoy tenure of ten years or more, 25.9 per cent, 20 years or more, and 41.3 per cent of those aged 35 or above, 20 years or more; the corresponding figures for women are 32.7 per cent, 11.0 per cent and 22.2 per cent respectively (Ono, 2007, pp. 23–4, 47).

Further, even for the small cadre of mostly male core workers in larger firms, lifelong employment is not a promise of a job for life. In most cases core workers enjoy seniority-based wage increases only until the age of 55. After that age, they face two choices. First, they may be offered early retirement packages. As of 2000, 58.2 per cent of companies with more than 5,000 employees and 43.0 per cent of firms with 1,000–4,999 employees offered schemes for early retirement. Second, they (along with other redundant workers) may be deployed to smaller firms on lower wages. This is possible

because an entire secondary labour market of subcontracting and other affiliated firms surrounds the larger companies. These firms soak up surplus labour from upstream and, therefore, bear the brunt of market instability (Coates, 2000, p. 130).

Finally, going against popular views of the firm as a benevolent provider of employee welfare, lifelong employment has its dark side, too. The price for job security – limited as it may be – is that core workers are subject to management's power to 'arbitrarily structure work arrangements and command labour' (Mouer and Kawanishi, 2005, p. 61). This power over employees is due to two features of the lifelong employment system. First, by virtue of their company-specific technical training, Japanese workers are trapped within their firms. Second, the prospect of deployment to the 'vast and unprotected peripheral sector' motivates workers to work hard to protect their salaries and working conditions (Coates, 2000, p. 131). The consequences of this are long hours, high levels of job-related stress, and limited time spent with family or on personal interests. In the mid-1990s, for example, Japanese workers typically worked 500 hours per year more than their counterparts in France and Germany (Coates, 2000, p. 131). Long hours and high job-related stress have led to an emerging social problem of *karoshi* (death by overwork: Coates, 2000, p. 131). This has led to government efforts to curb the amount of time spent at work. As a matter of law, Japanese workers cannot be forced to work more than 40 hours a week. However, male white-collar workers typically endure an hour or more commuting each day on crowded trains, and are expected to participate in after-work socialising with colleagues or business associates, thereby restricting family and personal time (McAlinn, 2007, p. 405).

Lifelong employment, then, is hardly a defining feature of industrial relations or corporate governance in Japan. It applies to less than 10 per cent of all corporate entities, barely 20 per cent of all workers, and only 8 per cent[2] of all working women. Even if lifelong employment *were* dying, this is hardly a strong basis to project major shifts in Japan's corporate governance system or capitalist configuration. Nor, given the enormous powers management have to command labour even for core workers, is lifelong employment the radical departure from at-will employment practices that are said to define more liberal market economies. Therefore, empirical evidence of any erosion of lifelong employment is hardly a marker of 'Americanisation' of corporate governance (compare Kelemen and Sibbitt, 2002; Hansmann and Kraakman, 2001). Nor does it prove convergence on the liberal market model of capitalism.

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[2] This is calculated from Ono's study of tenure distribution in 1998. Ono (2007, p. 48) finds that 21.4 per cent of Japanese workers have a tenure of 20 years or greater and that the ratio of men's average tenure to women's is 1.6.

2. WHAT ACCOUNTS FOR THE EXISTENCE OF LIFELONG EMPLOYMENT?

However, is lifelong employment coming to an end in Japan? Given the enormous scholarly attention this question has attracted – and the fact that lifelong employment is an observable trait in Japan's larger and internationally reputed firms – this question still merits some attention. This remains true even if it is an elite institution and insufficiently widespread to justify generalisations about the direction of Japan's corporate governance and system of capitalism. But before analysing the available quantitative and qualitative data, the first step is to explore the different theoretical models used to account for the *existence* of lifelong employment in Japan to date. This should provide us with some insights into the expected *fate* of lifelong employment since the recession of the 1990s. Specifically, this section explores and evaluates four key explanatory models – the market model, the cultural model, the institutional model and the political model.

2.1 Market Model

The market model – drawing on neo-classical economic growth theory and the rational choice of self-interested individuals – is not a popular explanation of lifelong employment. Nor is it particularly well-developed. However, it does find voice in the work of Miwa and Ramseyer (2002). Given the provocative nature and considerable impact of their research on Japanese law and political economy – developed together, separately and with other collaborators – this model deserves critical scrutiny.[3]

The upshot of the market model is that lifelong employment offends basic market principles. Employers want to hire during times of need and fire when their needs have been met. If Japanese firms wanted to give job tenure for life, they would have offered standard-form, long-term contracts and purchased insurance to cover paying wages during economic downturn. Yet, they never did. Indeed, as this chapter has already established, the vast majority of firms, especially SMEs, do not offer lifelong employment. This explains why, according to official statistics, mean tenure rates in Japan closely match those in many European countries and, just as in the United States, demonstrate significant inter-industry variation based on the transferability of skills rather

[3] See also Milhaupt (2002) and Puchniak's Chapter 4 in the volume (both focusing on 'main banks'); Upham (2005) (on Ramseyer's view of the Japanese judiciary); Freedman and Nottage (2006) and Puchniak (2007b) (the most wide-ranging critiques).

than any uniform preference for company-specific skills-training (see also Ogawa, 2003, Table 6). To the extent then that larger firms do retain their 'core' staff, the market model posits that this is because unfair dismissal laws effectively prevent larger firms from firing to protect their profit margins (see further Section 4 below). If it were not for the law, claim Miwa and Ramseyer (2002; 2006, p. 159), lifelong employment would never exist.

As an explanation of lifelong employment, the market model has much to commend it. First, it accurately demonstrates that lifelong employment is a minority institution. Second, it shows that employers prefer to relieve themselves of their surplus labour during economic downturn, which, as this chapter has established, is clear even in larger firms with managers deploying older workers to lesser positions or offering inducements for early retirement. The difficulty with the model, however, is that lifelong employment – even as a minority institution – *pre-dates* unfair dismissal law (Milhaupt, 2002). This rebuts the argument that unjust dismissal law *caused* lifelong employment as an example of market malfunction. This failure opens up wider concerns about both the descriptive rigour and the normative dimensions of the economic fundamentalism that defines the market model (Freedman and Nottage, 2006). First, the weakness of the model highlights the problem of formalising Japan (or indeed any other society) as a set of interdependent markets, and of framing all financial and social problems as related to market disequilibria (Boyer and Yamada, 2000, p. 4). Second, it opens up to critical scrutiny the tacit approval the model gives to at-will hiring and firing as a 'natural' operation of market forces. Such a view ignores the human cost and the power inequality inherent in market-based employment practices (Burkett and Hart-Landsberg, 1996, p. 62).

2.2 Cultural Model

Compared with the market model, the cultural model is a far more popular explanation of lifelong employment. The thrust of this model is that Japanese cultural preferences have informed the lifelong employment system. Strong group consciousness among the Japanese underscores employee loyalty to the firm. The importance of extended family (*ie*) relationships enables employees to see the firm as a substitute family which, in turn, fosters cooperative, collegiate relationships. The vertical integration of social organisation guarantees diligence by employees and the paternal benevolence of employers. The aversion to 'black-and-white' law ensures that the promise of job security does not require formalisation into a written contract. The preference for harmony over conflict ensures industrial peace and the humanistic practices of personnel managers. As Coates (2000, p. 127) puts it:

> The main claim often made by cultural analysts of Japanese worker–manager relations is not simply that postwar Japanese industrial relations have taken a particularly cooperative and harmonious form, but that they have done so primarily because both parties to the relations – both managers and workers – have carried within their heads particular sets of understandings of how social relations and economic life ought to relate. Japanese workers, we are told, lack the degree of class solidarity characteristic of Western European labour movements; and Japanese managers lack the unbridled individualism of their Anglo-Saxon counterparts. And because they do, because their heads are said to be full instead of a peculiarly Japanese version of Confucian thought, they have been able to establish among themselves a unique set of industrial relations practices which have harnessed the knowledge and commitment of Japanese workers to technological innovation and productive efficiency on an unprecedented scale – certainly on a scale without precedent in the US or UK liberal capitalism, and even on a scale beyond the capacity of the more negotiated capitalisms of the German or Swedish kind.

As an account of lifelong employment, the cultural model has provoked strong criticism (Mouer and Kawanishi, 2005, p. 55). The key problem with the model lies with the significance given to the variable of culture. First, 'culture' assumes a set of norms and behavioural practices that are universal and persistent (Coates, 2000, pp. 133–4). Yet, lifelong employment affects barely one fifth of the working population, so it is hardly universal. Nor is it a longstanding convention, even in larger firms. Historical research shows that, despite some early roots in the 1920s, lifelong employment was first institutionalised in the 1950s and only became popular from the 1970s onwards (Sako, 2005, p. 587). In addition to attracting scarce labour into the private sector, the pledge of lifelong employment was a political compromise between labour and management to preserve industrial peace. Until the immediate post-war period, Japanese unions were strong, militant and organised along industry lines (Coates, 2000, p. 133; Gilson and Roe, 1999). Second, if culture were the primary driver of industrial relations practices, then these practices should largely survive globalisation. Yet, according to some studies, foreign subsidiaries of Japanese multinationals are selective in the employment practices they export: they retain quality circles, long hours and enterprise unions, but they do not guarantee lifelong employment (Coates, 2000, p. 134).

2.3 Institutional Model

The institutional model of lifelong employment overcomes the drawbacks of cultural theories by emphasising the institutional architecture of Japanese post-war industrial organisation, and by explaining the economic logic that makes this institutional design a viable alternative to free and competitive markets. One of the leading exponents of this model is Aoki (1988, 1994, 2007). In his theory of contingent corporate governance, Aoki explains that

lifelong employment exists in a complementary and co-dependent relationship with a constellation of other institutions of corporate governance – such as main-bank monitoring, insider-dominated boards (see further Lawley, Chapter 6 in this volume), cross-shareholdings (highlighted by Kozuka, Chapter 10 in this volume) and a weak external market for corporate control (see Chapters 7–9 in this volume) – to form a cohesive, economically efficient system that promotes long-term productivity over short-term profiteering.

In very brief terms, the institutions cohere as follows. Insider boards ensure that management and employees have shared views and interests. *Keiretsu* cross-shareholdings create a stable set of shareholders who then protect management from the threat of takeovers and free them to take a longer-term view of productive growth. The main bank, as part of the *keiretsu* corporate group, monitors management and takes action when the firm shows sign of decline or difficulty. Lastly, the promise of lifelong employment enables workers to commit long-term to the firm, as well as encouraging them to work hard to avoid the threat of the main bank liquidating the business. Taken together, these 'complementary' institutions not only create an alternative model of corporate governance to that of shareholder primacy but also function, as 'rules of the game', to ensure its overall efficiency.

The institutional model, despite its many adherents (outlined by Nottage, in Chapter 2 of this volume), is not without its shortcomings. The first problem is its assumption of the a priori existence of institutional forms. The theory does not explain how Japanese institutional forms came into existence, nor why they coalesced into a cohesive system in the way that they did. The second is the notion of the 'systemic complementarity' or the structural fit of institutional forms. As Aoki (2007, p. 441) puts it, the institutions of Japanese corporate governance exist in a mutually reinforcing, dynamic relationship, with a change or breakdown of one institution triggering cumulative shifts in the other forms towards a new equilibrium. The difficulty with this view is explaining how an institutional architecture that, for most of the post-war period, sustained high growth in the Japanese economy, could suddenly lead to the prolonged economic slump in the 1990s and beyond. If there were a significant exogenous shock – such as the oil crises in the 1970s – this might provide an answer, but arguably the collapse of the asset bubble was largely an endogenous and domestic event (Boyer and Juillard, 2000, pp. 121–2). The third problem concerns the normative dimensions of the model insofar as it champions the Japanese system as an alternative model of stakeholder capitalism (Coates, 2005). Typical of this view is Puchniak (2008), who, in discussing the lack of hostile takeovers in Japan, lauds negotiated mergers and acquisitions as the 'efficiency of friendliness'. However, as already noted, the practice of lifelong employment, at least, is not without its harsh effects and, as Burkett and Hart-Landsberg (1996) argue, this should warn us against 'abusing' Japan as an example of 'progressive capitalism'.

2.4 Political Model

The final model draws on the institutional theory but meets its limitations. The political model – relying on both economic history (Gilson and Roe, 1999; Sako, 2005, p. 587) and the economic school of regulation theory (Boyer, 2001; 2005; Boyer and Juillard, 2000; Boyer and Yamada, 2000a, 2000b) – holds that lifelong employment was a political invention of the post-war period. As a political compromise forged between labour and management to preserve industrial peace and attract scarce labour away from government into the corporate sector (as mentioned in Section 2.3 above), lifelong employment has underpinned Japan's wage–labour nexus and has sustained its ensuing regime of accumulation.

The political model shares much with the institutional model. Like the institutional model, it believes in the structural complementarity of institutional forms in the economy. According to regulation theory, it is the *mode of regulation* that defines the substantive design of institutions or practices. In the case of lifelong employment, for example, the mode of regulation is that of 'flexicurity' – a balance between *security* of tenure and *flexibility* of working conditions (Wilthagen and Tros, 2004). Flexicurity means that core workers in major firms can obtain permanent positions provided they accept: (i) lower-than-market wages in the early stages of their careers; (ii) rotations across different departments and branch offices at the discretion of personnel managers; and (iii) the possibility of early retirement or deployment to smaller, affiliated businesses on lower wages in the later stages of their professional careers.

The regulation mode may be coherent, but it need not be stable. Regulation theory recognises that all capitalist systems contain inherent contradictions:

> social contradictions, political conflicts and economic unbalances are always present and eventually manifest themselves through crises during which the acceptance and viability of past institutional compromises are challenged. . . . In regulation theory, actors have no real capability for forecasting and thus overcoming structural crises, since these crises basically derive from the complex interaction of individual actions operating in distinctive fields. (Boyer, 2001, p. 116)

Therefore, the very success of a regime of accumulation can lead to its structural crisis (Boyer and Yamada, 2000, p. 13). Lifelong employment exhibits this contradiction. On the one hand, job stability provides the means for the long-term skilling of the workforce. On the other, it prevents firms from taking prompt action to reduce their costs during downward business cycles.

Unlike the market and the institutional models, the political model acknowledges that social relations and strategic political choices govern the design of the economy. To be sure, Aoki recognises the importance of the

polity (2007, pp. 445–7), but he sees this more as one of the mutually reinforcing pillars of the institutional system rather than the underlying basis of the economic system. The political model, by contrast, sees institutional forms as rooted in the political economy. As a result, the model holds that there can be multiple economic trajectories due to the infinite architectural choices available depending on the political conflict, social struggles and economic crises confronting a society in its history. It also deduces that a convergence to a market-based system is neither inevitable nor desirable (for example, Boyer, 2001, 2007; Boyer and Yamada, 2000, p. 12; Jacoby, 2005c, p. 623; Hollingsworth, 1997a, 1997b).

Another distinction between the institutional and political models is that the latter accepts unequal power differentials and the hierarchy of institutional forms, whereas the former tends to visualise institutions as equally contributing to the 'rules of the game'. According to the political model, lifelong employment is more than just a 'complement' to the main bank system and cross-shareholdings. It is a practice situated in a two-tiered corporate sector in which workers divide into an elite core working for large, public firms, and the peripheral majority typically employed in (or deployed to) smaller firms with inferior working conditions. This recognition of inequality enables a normative turn in evaluating the Japanese system of corporate governance. Whereas the institutional model holds that the Japanese system is a no less equally efficient and a more attractive option than markets allowed free rein, the political model affords a more sceptical perspective. For example, it can better capture the exploitative side to the practice of lifelong employment (Coates, 2000, p. 132).

3. IS LIFELONG EMPLOYMENT ACTUALLY DYING?

These different theoretical models provide us with different messages about the likely future of lifelong employment following the extended recession of the 1990s and early 2000s:

1. The market model predicts that employers' preference for at-will hiring and firing will replace lifelong employment once regulatory barriers to market-based employment practices are dismantled.
2. The cultural model predicts that lifelong employment will survive as long as Confucian values, such as group solidarity, loyalty and harmony, endure as defining traits of the Japanese psyche.
3. The institutional model predicts either the robustness of existing institutional arrangements or incremental, complementary dynamic change resulting in an overall shift in institutional equilibrium (Aoki, 2007).

4. The political model predicts that lifelong employment may cause a structural crisis due to its inherent contradictions, but its mode of regulation (flexicurity) is unlikely to disappear until a new wage–labour nexus is negotiated.

How well do these different predictions fit the available quantitative and qualitative data on changes to lifelong employment since the 1990s? This section draws on a wide range of empirical evidence – from anecdotes and newspaper reports to attitudinal surveys, industry-wide questionnaires and statistical models – to determine the extent to which lifelong employment is a dying practice. The section also queries the extent to which these data relate changes to lifelong employment to: (i) the primacy of market forces, (ii) the endurance of cultural values, (iii) incremental institutional change, or (iv) a crisis in the flexicurity mode of regulation.

3.1 Death?

According to one group of commentators, lifelong employment is gradually eroding. McAlinn (2007, p. 408), for example, reports an upward trend in job mobility in Japan in the early 21st century and an apparent decline of generic skills-training in favour of more focused specialities, such as in-house legal practice (see also Kitagawa and Nottage, 2007). Economic writers at the *Yomiuri Shimbun*, one of Japan's four major daily newspapers, predict the development of a stronger, more competitive external market for labour in Japan. The newspaper sees the emergence of the 'new' Japanese white-collar worker (*shinsha sarariiman*) who is more willing to test his or her worth on the open market and seek merit-based remuneration accordingly (Mouer and Kawanishi, 2005, pp. 258–9).

These anecdotal and journalistic accounts have some support in survey data. One survey, by the Japanese Electrical, Electronic and Information Union (Denki Rengo), showed a decline among its member firms in providing a long-term commitment to its employees over the past two decades (Mouer and Kawanishi, 2005, p. 250). A survey by Nikkei Research in February 2002 similarly indicated that over half of the 800 firms surveyed could no longer sustain permanent employment practices (Moriguchi and Ono, 2006, p. 167). Another, of the 805 firms listed on the Tokyo Stock Exchange and JASDAQ in November 2001, revealed that 82 firms had announced that they would retrench a total of 120,000 workers (Moriguchi and Ono, 2006, pp. 167, 172). Further, an international comparative study of listed companies with more than 2000 employees found an increasing proportion of Japanese firms downsizing their workforce by 10 per cent or more during the recession. In 1991, the proportion was 2 per cent; in 2001,

it had tripled to 6 per cent; and in 2002, it had peaked at close to 11 per cent (Jackson, 2007, pp. 286–7).

Two quantitative studies conclude that lifelong employment is not just eroding; it is facing extinction. In his 2003 longitudinal study of the employment practices of large Japanese firms in key industries from 1960 to 2000, Inagami (cited in Mouer and Kawanishi, 2005, p. 259) found that most large firms maintained lifelong employment commitments until the 1990s, supported by other practices such as deployments to other affiliated firms. However, by the turn of the century, firms could no longer sustain these practices and, accordingly, have weakened their commitment to provide job security to their core employees. Ahmadjian and Robinson (2001) are even more forthright in their claims. Analysing 'downsizing events' among publicly listed companies between 1990 and 1997, they identified a domino effect. Initially, Japanese firms – especially, older, high-reputation and wholly domestically owned firms – were reluctant to downsize their workforce, but they found 'safety in numbers' as more firms (led by those with a significant proportion of foreign shareholders) reduced their labour force (see Table 3.1). As a result, they believe their data support conclusions of the 'deinstitutionalisation' of lifelong employment.

3.2 Survival?

However, these conclusions sit uneasily with other empirical evidence. Abe and Shimizutani (2007, p. 347), for example, cite recent studies indicating a general *increase* in job tenure for full-time workers until the mid-1990s – and even until 2000. Further, a series of surveys on hiring practices among large Japanese corporations points to the continuance of lifelong employment practices. For example, a survey by the Japan Institute of Labour in 1999 found that 33.8 per cent of respondents (690 companies out of 2,370 that employ 1,000 or more workers) intended to maintain lifelong employment, 44.8 per

Table 3.1 Annual downsizing rate (number of downsizings divided by the number of firms in sample)

Size of downsizing	1990	1991	1992	1993	1994	1995	1996	1997
2% or more	0.175	0.126	0.142	0.191	0.311	0.438	0.513	0.518
5% or more	0.059	0.038	0.049	0.106	0.159	0.205	0.240	0.222
10% or more	0.027	0.016	0.015	0.042	0.074	0.085	0.071	0.075

Source: Ahmadjian and Robinson (2001, p. 634)

cent would retain it in modified form, and only 17.1 per cent would revisit the practice (Yamakawa, 2001, p. 630). A METI survey on the Corporate System and Employment in 2003 (cited in Jackson, 2007, p. 283) likewise revealed that most Japanese firms still commit to lifelong employment either in whole (85 per cent) or in part (2 per cent). Most of these firms, however, have abandoned the seniority-based wage system (45 per cent) or at least partially waived it in favour of a merit-based salary structure (34 per cent) (see Table 3.2). Finally, a Ministry of Finance survey in 2002 (cited in Jackson, 2007, p. 283) presented slightly different results on pay systems, but backed up the findings on the resilience of lifelong employment practices. Thus, 79 per cent responded that they maintain traditional lifelong employment, 50 per cent with seniority pay and 29 per cent with performance-based pay; only 16 per cent of firms responded that they do not offer lifelong job tenure.

Adherents to the cultural model of lifelong employment might take heart from these figures and argue that Japanese employers and employees still value a mutually inter-dependent relationship. However, Kwon (2004, pp. 336–7) documents a number of survey studies that reveal the decline of trusting relationships in Japanese workplaces. For example, a study by Nikkei Research Inc. in 1995 found that one quarter of employees in large firms felt a fading sense of belonging to their firm. Another study by Manpower Inc. on International Employee Loyalty in 2002 showed that Japanese workers had a significantly lower level of loyalty to their firm than their peers in the United States and Germany. The same study also disclosed that a substantially greater proportion of Japanese personnel managers, compared with those in the United States and Germany, did not believe in the importance of employee loyalty for ensuring business success.

Proponents of the market model might find little among the above empirical data to support their theoretical position. But nor does the data necessarily rebut it. After all, one of the planks of the market model is that regulatory

Table 3.2 Types of employment system among Japanese corporations

	Percentage of firms
Lifetime employment, no merit pay	8
Lifetime employment, limited merit pay	34
Lifetime employment, merit pay	43
Limited lifetime employment, merit pay	2
No lifetime employment, merit pay	12
Other	1

Source: Jackson (2007, p. 283)

barriers are preventing firms from adopting 'rational' hiring and firing strategies. However, the results of attitudinal surveys certainly do not lend support to the model's more basic assumption that Japanese managers 'prefer' market-based employment principles. Araki (2005, pp. 50–51) refers to two such surveys. The first, by the Japan Productivity Centre for Socio-Economic Development in 2003, showed wide support for a stakeholder model of corporate governance among not only union leaders but also management and human resources directors. In response to the question of to whom should corporations distribute their profits, the respondents answered that it should be distributed evenly among shareholders, employees, internal reserves and business investments. The second, by the Policy Research Bureau in the Ministry of Finance also in 2003, demonstrated that most firms regard employees as equally important as shareholders. Indeed, the proportion of firms placing such importance on employees rose from 27.3 per cent in 1999 to 28.5 per cent in 2002.

3.3 Dynamic Change?

If lifelong employment is neither on its deathbed nor unscathed by recent economic pressures, might a more moderate view provide a more convincing assessment of its recent transformation? In this context, it is worth testing Aoki's (2007) theory of contingent governance and dynamic, complementary change – representative of the institutional model of lifelong employment. According to Aoki, shifts to interlocking governance mechanisms, such as the decline of stable shareholdings, the rise of outside directors and the increase in foreign investors, should have an impact on employment practices.

A number of quantitative studies provide compelling support for this thesis. Abe (2002), for example, analysed the extent to which shareholding levels by banks and affiliates influence employment adjustment. He examined the financial information of listed firms in the chemical manufacturing, iron and steel, electrical machinery, and wholesale and retail sales industries. Abe found that when more shares are held by affiliate companies, employment adjustment either slows down or has no effect during times of loss. When more shares are held by banks, however, employment adjustment slows down or has no effect during normal trading periods, but accelerates during times of losses. This is consistent with the view that cross-shareholdings shield directors from acting in the short-term interest of shareholders, but that the main bank intervenes in management during trading difficulties. The upshot of this analysis is that there is a strong possibility that financial deregulation, the decline of cross-shareholdings and more foreign investment will greatly influence employment practices.

Yoshikawa et al. (2005) examined the effect of ownership structure on

firm-specific investments in human capital. Analysing the financial data of 996 manufacturing firms over five years (1998–2002), they found that domestic owners tended to support investment in human capital over sales; this was especially pronounced when performance was low. By contrast, foreign investors tended to reduce wage intensity during business downturn. Yoshikawa et al. conclude that the growing influence of foreign investors should 'exacerbate' cost-cutting measures. These findings are consistent with the study by Ahmadjian and Robinson (2001), which also found that foreign investors played a leading role in putting pressure on the lifelong employment system.

Finally, Abe and Shimizutani (2007) examined the impact of changes in board composition and ownership structure of listed firms in Japan on labour cost reduction strategies. Employing a unique firm-level data set combining the degree of perceived excess employment, board composition, ownership structure, labour cost reduction measures, and financial statement data, Abe and Shimizutani found that outsider directors were more likely to implement layoffs and/or voluntary or early retirements, while insiders were more inclined to decrease new hiring. They argue that these results indicate that outsider directors contribute to the downsizing of employment, whereas insiders prefer to protect incumbent employees (p. 363).

Although these studies furnish interesting results, they are subject to a number of limitations. Although all the cited studies (except for Ahmadjian and Robinson, 2001) demonstrate a relationship over time between lifelong employment and other governance institutions, they do not establish empirically that lifelong employment itself has fundamentally changed in response to shifts in cross-shareholdings, main bank monitoring, foreign ownership or insider boards. Indeed, if anything, the size of these other variables seems quite small. Consider, for example, the study by Abe and Shimizutani (2007, p. 353) on outside directors. According to their descriptive statistics, the proportion of insider directors on Japanese boards was relatively high in 2001 (M=0.6726, SD=0.2308) and has not significantly changed since 1991 (M=0.7003, SD=0.2188). Likewise, the descriptive statistics for the proportion of foreign investors relied upon in the project by Yoshikawa et al. (2005, p. 288) are minuscule (M=0.06, SD=0.09), especially when compared with the proportion of domestic owners (M=0.59, SD=0.14).

3.4 Intensification and Crisis?

Given these shortcomings, might the political model provide a more satisfying explanation of the conflicting evidence? Under the political model, lifelong employment is a strategic choice to institutionalise flexicurity in a two-tiered market of employment relations. Flexicurity, as a mode of regulation, may not

necessarily be structurally stable and its exposure to prolonged recession might have precipitated a structural crisis. However, until a new deal on the wage–labour nexus can be reached, it should continue to define the employment system.

Some recent quantitative studies offer empirical support for this model. First, there are survey data that rebut the view that larger companies in Japan are uniformly downsizing their workforces (compare Ahmadjian and Robinson, 2001). Instead, larger firms seem to be intensifying flexible employment techniques in a bid to avoid excessive over-supply of labour. In addition to past practices focusing on older workers, such as (i) early retirement schemes and (ii) deployment to smaller, affiliated firms, Japanese companies are also increasingly resorting to (iii) cuts or freezes in graduate entry programs. So much is evident from a METI survey conducted in 2003 on methods of employment adjustment, summarised in Table 3.3.

Second, as Table 3.2 also demonstrates, Japanese companies are still standing by their core employees. This is because outright dismissals remain rare

Table 3.3 Methods of employment adjustment, 2000–03

Adjustment method	All firms (%) N = 246	No adjustment (%) N = 159	Cutting 10%+ (%) N = 87	Cutting 25%+ (%) N = 19
Restricting overtime	14	13	16	11
Shorter hours	3	1	6	9
Cut in mid-year hiring	16	16	16	21
Reduction in outsourcing	9	8	9	9
Reallocation	28	23	36	20
Transfer to other companies	26	20	37	37
Cut in hiring new graduates	44	34	61	63
Reduction of non-regular employees	14	14	13	11
Layoff	5	3	8	5
Voluntary early retirement	28	16	49	58
Other	2	1	6	11
No adjustment method	35	46	10	11
Percentage change in employees	13	33	–20	–37
Per cent of sample	100	65	35	8

Source: Jackson (2007, p. 290)

and a tool of last resort (Moriguchi and Ono, 2006, p. 168). In their study of downsizing among listed Japanese companies, Ahmadjian and Robinson (2001) seek to make out the contrary case. However, by conflating 'layoffs' and 'transfers' in their construction of the variable 'downsizing event', they fail to establish that overall downsizing is consistent with an abandonment of secure tenure for elite workers. This, in turn, seriously undermines their conclusion that lifelong employment is a crumbling institution.

To be sure, the core of employees protected by lifelong employment *is* shrinking (Aoki, 2007, p. 432; Araki, 2007, p. 255). For example, non-standard workers – part-time, casual and agency workers – are occupying a larger share of the labour market than permanent employees. Between 1997 and 2001, the number of full-time employees fell by 1.71 million while the number of non-standard workers rose by 2.06 million (Kwon, 2004, p. 338). In the 15 years since 1990, the proportion of non-standard workers grew from one-fifth to nearly one-third of the working population. In 1990, non-regular employees comprised 20.2 per cent of the labour market; in 1994, 22.8 per cent; in 1999, 27.5 per cent; and in 2004, 31.5 per cent (Yamakawa, 2001, p. 629; Araki, 2005, p. 36). Even so, as Ono (2007, p. 35) observes, it is important to unpack the factors that are causing this effect, rather than rush to judgment based on their net effect:

> Much of the disagreement regarding changes in lifetime employment stems from confounding or not disaggregating the inflow, outflow and the stock of workers. One interpretation is that although the population of workers who are ex-ante covered by lifetime employment may be shrinking, the likelihood of job separations has remained stable for those who are already in the system. Consider the analogy between the labour force and the bathtub where the water flowing into the tub represents the flow of workers into the core, water flowing out is the flow of workers out of the core, and the water level in the tub is the employment level (or the stock) of the core workforce. In this analogy, the water level remains the same or decreases because: (i) There is little water being eliminated from the tub; and (ii) Preserving the current water level requires choking off the flow of water into the tub. The mobility measures add support to this effect. In the 1990s, new graduates were significantly less likely to enter the labor force as standard workers than in previous periods. This led to two outcomes. First, standard employment declined relative to non-standard employment, which led to an overall reduction of the core workforce. And second, the expansion of the non-standard workforce among younger workers resulted in their higher job mobility (as characterized by their lower retention rates and higher separation rates). In contrast, job mobility among older workers remained virtually unchanged during the 1990s (with the exception of the post-retirement age group).

Third, studies show that the intensification of flexible employment practices is causing a structural crisis in Japan. For example, employees of smaller companies are disproportionately bearing the brunt of the recession. As Matsui

shows in Chapter 5, SMEs are no longer able to soak up redundant workers from upstream, and have succumbed to insolvencies in record numbers. Further, as Ogawa (2003) demonstrates, the recession has affected employment levels in smaller firms far more acutely than in larger firms, as shown in Table 3.4.

The upshot of all this empirical evidence is that lifelong employment persists, but is under strain. The intensification of the flexicurity dynamic has culminated in: (i) preserving job security for incumbent core workers, (ii) squeezing out older and younger workers from the benefits of permanent tenure (they now join women on the 'outside' of the system), (iii) disproportionately burdening the SME sector with the fixed cost of surplus labour, and (iv) encouraging greater casualisation of the Japanese workforce. A crisis in Japanese industrial relations is now in train. Large-scale businesses, which introduced lifelong employment in the 1950s to lure skilled and committed workers, are beginning to lose their attraction as places to work (Kwon, 2004, pp. 336–7). The command that management can now exercise over labour is strengthening (Mouer and Kawanishi, 2005, p. 111). To make matters worse, the chasm between the elite core and the periphery is widening (Coates, 2000, p. 134).

Table 3.4 Change in current employment by an increase of the debt–asset ratio from the 1st to the 3rd quartile in 1998

	Small firms (%)	Large firms (%)
Manufacturing		
Chemicals	–1.28	1.09
Machinery	–1.65	0.95
Electrical machinery	–1.89	1.10
Transport equipment	–1.12	0.90
Non-manufacturing		
Construction	–18.53	–0.13
Wholesale trade	–19.70	–0.13
Retail trade	–24.85	–0.15
Real estate	–36.55	–0.22

Source: Ogawa (2003, p. 21)

4. WHAT ROLE DOES LAW PLAY IN THE LIFELONG EMPLOYMENT SYSTEM?

Most legal scholars agree that the Japanese labour law regime erects a regulatory structure that directly supports this dynamic of flexicurity (Araki, 2005, 2007; Foote, 1996; Yamakawa, 2001). The law ensures security by vesting employees with a general right against unjust dismissal. It promotes flexibility by arming employers with the flexibility to alter working conditions, effect internal rotations and external transfers, build a casual workforce, and control working times. Due to a recent mix of 'deregulatory and reregulatory measures' (Araki, 2007, p. 278), Japanese law has reinforced this original design as well as paving the way for the intensification measures described in the previous section (Yamakawa, 2001, p. 632). Thus, the protections on job tenure remain largely in place. Indeed, they are bolstered by recent initiatives to keep pace with evolving social values about privacy, gender equity, whistle-blowing and life/work balance (Araki, 2007, pp. 273–4, 277–8). Conversely, a spate of deregulatory moves has broadened the powers of employers to deal flexibly with working conditions.

4.1 Security

The judicial doctrine against unjust dismissal is the glue that binds employers to their 'implicit' promise of lifetime job security. Although the Labour Standards Law (No. 49 of 1947) entitles an employer to discharge an employee by providing four weeks' notice, the courts have emphasised the importance of stable and existing relationships by protecting vulnerable employees against arbitrary dismissal (Foote, 1996; compare Kettler and Tackney, 1997). The Supreme Court first recognised the unjust dismissal doctrine in 1975, holding that it was against the 'common sense of society' to permit an employer to dismiss an employee without 'reasonable grounds' (25 April 1975, 29–4 Minshu, p. 456). It has been strictly enforced ever since. In one widely cited decision, the Supreme Court (31 January 1977, 268 Rodo Hanrei, p. 17) invalidated the dismissal of a presenter of an early morning news bulletin who had overslept twice in a fortnight, once missing the entire broadcast and another time missing half of the programme. Although the company argued that the employee was irresponsible and his actions had harmed the reputation of the station, the Court ruled that the dismissal was unduly harsh and unreasonable. The Supreme Court (20 July 1979, 33–5 Minshu, 582) further invalidated, as abusive, the withdrawal of a provisional offer of employment to a university graduate whom the personnel director later thought was too 'gloomy' for the position.

The courts have particularly scrutinised economically motivated retrench-

ments. In one decision, the Niigata District Court (26 August 1966, 17–4 Rominshu, p. 996) held that a company had abused its right to dismiss by reducing its workforce simply to improve profitability and enable dividend payments to shareholders. The Court held that retrenchments of this type should be a last resort in the face of persistent, not temporary, trading difficulties. Following this decision, the courts have developed a stringent four-part test for determining the validity of adjustment-related dismissals: (i) there must be a compelling business need to reduce staffing levels; (ii) management must have duly considered other options for coping with its business problems and resorted to adjustment-related dismissals only as an unavoidable last step; (iii) the selection of staff for retrenchment must be objectively reasonable; and (iv) employers must make a bona fide effort to consult with the union or worker group about the necessity, timing, scale and method of any dismissals. This four-part test explains why lifelong employment is more strongly embedded in larger than smaller firms. Since larger firms have greater financial capacity to cope with business downturns and more tools available to them to regulate surplus labour (such as secondments to other related entities, early retirements and new hire freezes), the onus of satisfying the four-part test is much greater than for SMEs.

However, in a recent controversial case, the Tokyo District Court (21 January 2000, 782 Rodo Hanrei, p. 23) seems to have slightly relaxed the test even for larger companies. Holding that the four-part test must be viewed holistically, the court ruled that each of the prongs in the test must be treated as a 'factor' to be considered, rather than a 'requirement' to be established. Although this decision has sparked controversy among pro-labour lawyers, it has been confirmed in subsequent judicial decisions. The new standard is thought to ease the burden on larger firms seeking to restructure during economic downswings, but it does not signal a new judicial openness to at-will discharges (Araki, 2005, p. 38).

In 2003, the Labour Standards Law was amended to incorporate the judicial doctrine against unjust dismissal. Article 18(2) now provides: 'Where a dismissal lacks objectively rational grounds and is not considered to be appropriate in general societal terms, it shall be null and void as an abuse of right.' The employer must also give 30 days' notice of the dismissal (art. 20) and, if requested, provide reasons to the employee (art. 22). The government had initially proposed to incorporate a provision confirming the right of an employer to dismiss, but this was dropped from the bill after objections from labour unions, the opposition parties, the Japan Federation of Bar Associations and other groups (Araki, 2005, p. 40).

Although the amendments to the Labour Standards Law merely codify the judicial doctrine against unfair dismissal, rather than significantly modifying or clarifying its scope, other legislative reforms have strengthened job security

for employees in line with changing social values. For example, the Whistleblowers Protection Law (No. 122 of 2004) prohibits dismissal by reason of whistleblowing in the public interest (art. 3). The Equal Employment Opportunity Law (No. 45 of 1985) was amended in 1997 and 2006 to strengthen the rights of working women, including prohibiting dismissals attributable to direct or indirect discrimination. Further, the Child Care and Family Care Leave Law (No. 76 of 1991), revised in 2004, prohibits an employer from dismissing or treating a worker disadvantageously by reason of the worker applying for or taking eligible child care leave (art. 10), family care leave (art. 16) or leave to care for a sick or injured child (art. 16(4)).

4.2 Flexibility

To accommodate the restrictions on employee dismissals, Japanese law provides employees with a number of tools to ensure flexible working practices. These tools roughly divide into two types: (i) those that empower management to command labour; and (ii) those that allow the outsourcing of work (Mouer and Kawanishi, 2005, p. 111). Recent legislative amendments have mostly operated to increase these powers.

First, Japanese corporate and competition law affords firms considerable freedom to structure their businesses into an enterprise group (as outlined in the Appendix to this book's introductory chapter and emphasised in Kozuka's concluding chapter). The longstanding prohibition on holding companies since the end of the war was lifted by 1997 reforms to the Anti-Monopoly Law (No. 54 of 1947, amended by No. 87 of 1997). Subsequent reforms to the Commercial Code in 1999 and 2000, retained in the new Company Law (No. 86 of 2005), facilitated the creation of holding companies and corporate divisions by obviating the need for the individual consent of creditors. This reform has allowed firms to create more distinct business units through which they can rotate their personnel freely (Inagami and Whittaker, 2005, Ch. 6). Corporate restructures, however, cannot be used unilaterally to streamline staff numbers. By virtue of the Labour Contract Succession Law (No. 103 of 2000), workers' labour contracts are automatically transferred to the new entity in the event of a corporate division.

Second, the Labour Standards Law authorises employers to unilaterally alter working conditions, including specifications about the type and place of work. This frees up Japanese companies to transfer redundant staff, regardless of their objections, to other divisions or affiliated businesses. Although the Law provides that the employment contract must specify the conditions of work, including the location and required duties, it also allows employers to promulgate work rules that apply across the whole organisation (art. 89). Employers are expected to consult with worker representatives, but are not

required to obtain their consent. Employers typically reserve in their work rules a right to transfer staff and the courts have generally not interfered with the exercise of this right.

Third, a range of judicial and legislative developments permits employers to worsen working conditions to protect their firms against deteriorating business conditions. For example, the Supreme Court (25 December 1968, cited in Araki, 2007, p. 251) has held that companies may make an unfavourable modification of their work rules, provided they are reasonable in the circumstances. In addition, although the Labour Standards Law states that contractual working conditions cannot be inferior to the work rules (art. 93), the judiciary has allowed the converse – namely, work rules that are inferior to contractual conditions. Further, 1998 amendments to the Labour Standards Act have introduced a discretionary work scheme for most white-collar workers. This defines working time by reference to the tasks completed rather than the hours worked. Since this separates overtime entitlements from actual hours worked, the Law allows companies to control their overtime budgets as well as foster increased competition among workers and intensified working practices (Mouer and Kawanishi, 2005, p. 111).

Fourth, Japanese law has increased the power of firms to casualise their workplaces. Under former law, the legal maximum limit for an employment contract was one year. However, the 2003 amendment to the Labour Standards Law has increased this upper limit to three years. This is attractive to managers for two reasons. One is that it allows them to 'lock-in' a casual workforce rather than rely on annual contract renewals. The other is that it provides an opportunity to make strategic, medium-term hires of professional staff or skilled technicians and thereby externalise some of the cost of training. Although it is too early to report on the outcomes of this reform, one prediction is that it will create a three-tiered workforce comprising elite core workers, medium-term skilled workers and shorter-term repetitive labour (Mouer and Kawanishi, 2005, p. 115). Moreover, the Worker Dispatching Law (No. 88 of 1985) has been dramatically changed. It originally restricted legal dispatch of temporary workers to 16 highly specialised occupation categories, but the number of categories was raised to 26 in 1996. In 1999, the in-principle prohibition on worker dispatch was removed and the supply of temporary labour became available for most occupational fields (Araki, 2007, p. 276; Mouer and Kawanishi, 2005, p. 115). In 2003, the prohibition on dispatching workers to production sites was removed.

5. CONCLUSIONS

Lifelong employment in Japan is alive – and not well. Perhaps, it was not well

to begin with. But it is no closer to death now. Certainly, work has undergone a significant transformation in Japan. Unemployment has risen to unprecedented levels, soaring to a record 5.4 per cent in 2002 after hovering around 1–2 per cent until the 1990s (Jackson, 2007, p. 283). Atypical workers without stable working conditions – part-timers, casuals, freelancers, agency workers – have become more prominent, now occupying approximately one-third of the labour market. Graduate recruitment has declined.

The law has kept pace with these changes. While some statutes reinforce traditional commitments, such as protection against unfair dismissal, others have continued to deregulate labour markets. Deregulation allows employers greater freedom in structuring their businesses, moving their personnel around their enterprise structure, modifying work conditions to cope with weaker economic conditions, and taking advantage of temporary and short-term casual labour.

The central thesis of this chapter is that such changes are best understood as evidence of an *intensification* of an existing mode of regulation – flexicurity – rather than a harbinger of more dramatic institutional shift. The system is undergoing stress, clearly, but its key features remain in place. This conclusion becomes possible once the layers of myth and hyperbole are removed from the institution of lifelong employment and its true, naked form comes into proper view. Lifelong employment was never a common form of employment practice; it always served an elite minority of mostly male workers in prestigious firms, and it continues to do so. Lifelong employment was never a 'blip' on the operation of free markets; it always functioned to underpin a two-tiered labour market and still does so today. And lifelong employment was never an exemplar of a Confucian-inspired preference for relational harmony; it was (and remains) a tool to serve the needs of business.

This conclusion poses challenges for theories of dynamic institutional change. As Nottage summarises in the previous chapter, Streeck and Thelen (2005b, pp. 19–30) identify five forms of incremental change in political economies: displacement, layering, drift, conversion and exhaustion. Applying this taxonomy, Nottage argues that the attenuation of the commitment to core employees typifies 'exhaustion' of lifelong employment as an institution of corporate governance. Undoubtedly, of all the options outlined by Streeck and Thelen, this is the closest fit. But it is still not quite right. Lifelong employment, as this chapter has shown, is not 'withering away'; rather, it is reinventing itself in response to the intensification of the flexicurity mode of regulation. As the empirical evidence illustrates, the 'tree' of lifelong employment may have many of its branches swaying in the wind (some may have even snapped off), but this tree remains rooted in the same political compromise between labour and management settled over five decades ago.

This chapter also raises a challenge to corporate governance theory. As

Letza et al. (2004) describe, corporate governance theory tends to be divided into fixed, 'entitative' views of the firm – either individual entity or social entity. In the debate about transformations of corporate governance in Japan, the Japanese model is typically lauded (in good economic times) and decried (in bad times) as stakeholder' capitalism, in contrast to the Anglo-American model of 'shareholder primacy'. Yet these binary distinctions are artificial. Studies in the US (for example, Faleye et al., 2006) and Australia (for example, Jones et al., 2007) show that stakeholders *do* have an influence on governance practices – Puchniak (2007c) even highlights evidence of the 'Japanization of American corporate governance'. This chapter has emphasised that the influence of employee stakeholders has always been exaggerated in the Japanese case. Since lifelong employment is a governance technique that is not universal, ahistorical or neutral, we need new theories that take seriously the heterogeneous, transient and political dimensions of corporate governance.

Finally, this chapter opens up new possibilities for making alternative normative assessments about Japanese shifting configurations of governance and capitalism. For those who see Japan as a model of 'progressive capitalism', evidence of slippage into US-style market-oriented governance is a cause for concern. However, as this chapter has demonstrated, Japanese capitalism is not an outlier; it operates, like any other, as a *regime of accumulation*, albeit with its own defined set of strategic choices. In particular, there is nothing 'progressive' about lifelong employment. It is rooted in inequality, and always was. If anything, the inequality is increasing. As Coates concludes (2005, p. 193):

> There is a general lesson in this for all of us: the danger of establishing too close a linkage between political projects to reform capitalism and the defence of existing models of capitalism, however relatively superior those models may appear to be. For capitalism is not a system given to stasis. What works in one period is unlikely to do so in the next; and even when it 'works', its distribution of costs and benefits is never socially equal. So when deciding which tiger to ride, it is worth remembering that the choice is only between tigers; and that if a safe ride is what you want, you would do well not to ride tigers at all. For a time, a certain section of the intellectual Left forgot that, and ended up – if not with egg on their face – then at least with *sushi*.

4. Perverse rescue in the lost decade: main banks in the post-bubble era*

Dan W. Puchniak

Academic theories are attractive – especially to academics. When the theory is simple, contrarian, and championed by eminent Tokyo University and Harvard professors, it is almost irresistible. However, when it fails to make sense of reality, it quickly loses its appeal. So, despite the temptation to embrace Yoshiro Miwa and Mark Ramseyer's (M&R) new theory of Japanese corporate governance, which finds decades of research to have constructed 'a myth', I resist.

The story told by M&R is enchanting in its simplicity and universality. In their world:

> Whether in the United States or in Japan, firms raise funds in competitive capital markets, and buy and sell in competitive labor, service, and product markets. Whether here or there, in order to survive, they will need *good governance schemes*. . . . The scheme they pick will vary from firm to firm. The fact that they will pick the *optimal scheme* or die will not (M&R, 2002, p. 421, emphasis added).

It all sounds logical, because it is – unless unique and perverse institutional incentives, and not free-market forces, drive corporate governance.[1] In which case, the incentives for 'bad governance' and 'suboptimal schemes' may be greater than those for 'good governance' and 'optimal schemes'. Perverse it is, but mythical it is not.

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* This is an updated and condensed version of an article that was first published in the *Pacific Rim Law & Policy Journal*: Puchniak (2007a). For a further critique of M&R's free-market theory, see Puchniak (2007b), with acknowledgements for research funding and thanks to many people.

[1] In this chapter, the term 'institutional incentives' refers to incentives that are created by domestic laws, regulations, institutions, and formal and informal government policies and practices which provide payoffs for corporate executives to make certain governance decisions. Institutional incentives are referred to as 'perverse' when they provide a payoff for a governance decision that results in, or reinforces, economically inefficient behaviour. Institutional incentives are considered 'unique' because the matrix of domestic laws, regulations, institutions, and formal and informal government policies varies from country to country.

What M&R miss in their analysis is that Japanese firms, in their unique environment, are often driven by perverse institutional incentives to select schemes that may be beneficial to firm survival but may not be optimally efficient.[2] The consequence of firms responding to such incentives and picking suboptimal schemes is not, as M&R predict above, that they will die. While some may die, others may simply get 'sick' and later be bailed out by the government, while a few others may thrive on the perverse incentives. Whatever the result, one thing holds true: firms will adopt inefficient suboptimal schemes when the incentives to do so are greater than the incentives for alternative actions.

This chapter tells the perverse story of Japanese banks in the lost decade (1990–2002). As a result of being mired in non-performing loans arising from poor lending decisions in the 1980s, banks were on the verge of collapse. Many spent the lost decade treading terribly close to having insufficient healthy capital to continue banking operations. According to American precedent, unhealthy banks tighten lending, causing a 'capital crunch'.[3] Unhealthy banks definitely do not increase loans to risky clients. American precedent may apply to America, but it does not apply to Japan (Peek and Rosengren, 2005, p. 1144; Hosono and Sakuragawa, 2005, pp. 8–9).

American precedent and M&R's theory go hand in hand. In M&R's world, sophisticated banks with billions of dollars at stake 'do not spend good money after bad' – especially when there is little hope of recovering part of the bad (for example, M&R, 2006, p. 63; 2002, p. 417). With limited capital in a competitive market, standard economic theory would tell us that banks lend to their best clients (those with good governance, who choose optimal schemes and are thus most likely to repay loans), not their worst, or they die. A priori, firms that choose suboptimal schemes are deprived of capital and culled from the market. For banks to do the opposite – lend to their worst clients – is not rational in a free market. Based on M&R's theory, rational bankers will not take such seemingly self-destructive, economically inefficient actions (M&R, 2003, p. 22; 2005, p. 338; 2002, p. 421). Therefore, the best explanation is not

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[2] In this chapter, 'optimally efficient' refers to the scheme that a firm can select which produces the greatest possible economic benefits from its free-market transactions. In this sense, assuming a perfect market, if all firms make 'optimally efficient' decisions, the result will be Pareto optimality.

[3] A 'capital crunch' occurs when banks decrease their lending supply for some lender-specific reason. Many American researchers concluded that a 'capital crunch' occurred in the US in the early 1990s – worsening the recession at that time. The general consensus is that banks, in particular weaker banks, decreased risky lending and purchased government securities to meet the minimum capital requirements under the Basel Accord (Hall, 1993; Haubrich and Wachtel, 1993).

that Japanese bankers irrationally took such actions but rather that such actions did not occur at all. To say otherwise would be to create another 'myth'.[4]

Yet in the lost decade, unhealthy Japanese banks did the opposite of what American precedent and M&R would predict. To start with, banks lent more, not less.[5] This may seem strange, but does not qualify as perverse. What is perverse is that in lending more they increased lending not to their clients who were most likely to pay them back but rather to their clients who were *least likely* to pay them back (Puchniak, 2007a, pp. 36–42). Even more perverse is that they did not charge a premium to their worst clients to compensate for their increased risk.[6] As path dependence would predict, Japan's main banks took the lead in orchestrating the perverse scheme of systematically lending to loser firms, which in essence was 'main bank rescue' gone bad (Peek and Rosengren, 2005, pp. 1144–5; Puchniak, 2007a, pp. 57–9). Main banks rescuing loser firms does not sound like banks practising, or rewarding corporations for, good governance or choosing optimal schemes. Yet, in Japan's unique and perverse institutional environment, rescuing loser firms by lending them more at below-market rates made sense because it ensured survival.

To survive, which is the ultimate incentive, banks had to solve two problems: (1) to *appear* to decrease non-performing loans; and, (2) to *appear* to have enough healthy capital to continue operating. In Japan's unique institutional environment, lending to their worst customers solved both problems. It made non-performing loans appear as performing ones and increased the appearance of healthy capital. Therein lie the perverse incentives – which do not, any longer, seem so perverse. That is, if you were a senior executive of a Japanese bank during the lost decade.

Make no mistake. According to M&R's theory, 'good governance' and 'optimal schemes' would not include the survival tactics that Japanese banks used in the lost decade. In their world, such behaviour would not exist. Their assumption is that free-market forces drive Japanese banks to act in essentially

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[4] M&R use the logic that if standard economic theory cannot explain the alleged actions taken by Japanese firms, the best explanation is not that free-market forces do not drive the behaviour of Japanese firms, but rather that the alleged action never occurred at all (M&R, 2002, pp. 418–19; 2006, p. 147). Ramseyer has also deployed the Chicago School technique of arguing that if something manifestly does exist, it must be an efficient market response (Freedman and Nottage, 2006). For example, in explaining Japan's lack of hostile takeovers, in an earlier work he emphasised the incentives created by Japan's main bank and lifelong employment systems (Ramseyer, 1987).

[5] Peek and Rosengren (2005, p. 1144); Hosono and Sakuragawa (2005, pp. 8–9); Puchniak (2007a, n. 15).

[6] Caballero et al. (2006, pp. 5–12); Sekine et al. (2003, p. 78); Smith (2003, p. 283); BIS Report (2002, pp. 133–4).

the same manner as their American counterparts: to choose economically efficient schemes that maximise profits (M&R, 2006, p. 147). In their world, 'the truth about Japan is more logical, more mundane, more boring – and more consistent with standard, old-fashioned microeconomic theory' (M&R, 2002, p. 421). M&R are indeed correct in arguing that, according to standard old-fashioned microeconomic theory, 'most banks in the real world try to cultivate a reputation . . . for punishing default debtors [not for rescuing them by lending them more]' (M&R, 2002, p. 417). Unfortunately for M&R's theory, sometimes incentives created by a country's unique institutional framework, and not 'standard old fashioned microeconomic theory', explain reality.[7]

Indeed, the reality of main bank lending in the lost decade is the opposite of what M&R's theory would predict. Not only did main banks lend to their worst clients at below-market interest rates throughout the lost decade, but as a result of such lending the influence of main banks on Japanese corporate governance increased. This fact turns M&R's theory on its head. During the 1980s and the lost decade, Japan's financial markets were substantially deregulated. If M&R's free-market theory – which labels the main bank system and the institutional incentives that support it 'a myth' – has any chance of accurately explaining a period in post-war Japan, it would be the substantially deregulated lost decade. That M&R's theory so dramatically fails to explain main bank lending in this relatively deregulated era demonstrates the frailty of their theory.

The rest of this chapter proceeds as follows. Section 1 provides a brief overview of the conventional main bank rescue theory and explains why main bank rescue serves as a useful litmus test for M&R's free-market theory. Section 2 exposes the flaws in M&R's theory by demonstrating how it fails to predict the perverse rescue behaviour of Japanese banks in the lost decade. Section 3 concludes by explaining how this analysis of perverse main bank rescue and evidence of the increased reliance of Japanese companies on main bank lending in the lost decade demonstrate the continued significance of Japan's unique main bank system in the post-bubble era.

1. MAIN BANK RESCUE

1.1 A Litmus Test for M&R's Theory

Miwa and Ramseyer have labelled the conventional understanding of Japanese

[7] In this chapter, 'institutional framework' refers to the matrix of laws, regulations, institutions, and formal and informal government policies and practices that have an impact on Japanese corporate governance.

corporate governance 'a myth'. To them, the main bank system, *keiretsu*, lifetime employment and a market-manipulating Japanese government are nothing more than academic pipedreams (M&R, 2002, pp. 420–21). Although M&R use complex statistics to support their claims, the basic rationale underlying most (if not all) of them is simple: contemporary Japanese corporate governance can be explained by standard economic theory because it has essentially been driven by free-market forces (M&R, 2006, p. 147). The flipside of the coin is that unique incentives created by Japan's institutional framework (if they exist at all) do not need to be taken into account because they have had a *de minimis* effect on Japanese corporate governance.

Although M&R's recent research therefore attempts to debunk all of the major elements of the conventional theory of Japanese corporate governance, this chapter focuses primarily on one: main bank rescue.[8] The concept of main bank rescue provides an excellent litmus test for M&R's theory for a number of reasons. First, the logic used by M&R to challenge the concept is representative of their general approach (M&R, 2006, p. 160). Second, the concept of main bank rescue is of central importance to the conventional theory of Japanese corporate governance (Aoki et al., 1994, pp. 1–50). Third, the extensive empirical research that examines the lending behaviour of Japanese banks in the 1990s provides a robust tool for testing M&R's theory (Puchniak, 2007a, pp. 36–9).

1.2 A Theory Based on the Importance of Unique Institutional Incentives

The concept of main bank rescue is rooted in the more general Japanese main bank theory. According to that theory, Japanese firms borrow from many banks but have a special relationship with only one: their main bank. The relationship that firms have with their main bank differs from those with other banks in a number of important respects – one of which is that main banks make an implicit promise to attempt to rescue failing, but potentially productive, client firms when they encounter financial adversity (Aoki, 2000, pp. 60–94; Sheard, 1994, pp. 188–230).

It is important to clarify what the 'promise to rescue' entails. The promise made by main banks is to attempt – not to guarantee – to help restructure potentially productive (not all) firms rather than foreclosing on their loans in a time of financial crisis (Aoki, 2000, p. 71). The promise is not to provide a

[8] For a broader critique of M&R's theory, see Puchniak (2007b), and Freedman and Nottage (2006).

carte blanche for potentially productive firms to receive unconditional financial and managerial assistance in a time of crisis (Sheard, 1994, p. 190; Aoki, 1994, p. 123). On the contrary, as part of its rescue, the main bank 'actively intervenes, punishes and displaces managers, and sometimes the general work force, and oversees or engineers organizational and asset reorganizations' to improve firm productivity (Sheard, 1994, p. 211). To this end, after it is determined that the firm's financial difficulties are only temporary, or that restructuring is possible, the main bank may take a number of steps, including: (1) providing additional loans; (2) refinancing existing main bank debt; (3) guaranteeing the firm's other debts; and/or (4) sending members of the bank to act as managers or directors (Aoki, 2000, p. 71; Aoki et al., 1994, pp. 25–6; Sheard, 1994, p. 193; Ito, 1992, p. 116). If, however, the main bank's attempt to make a firm more efficient is thwarted by existing management, the main bank will cease its rescue attempt and let the firm fail (Aoki, 2000, p. 71).

Main bank rescue is efficient because the economic value of a potentially profitable firm as a going concern (with its firm-specific tangible and intangible assets) is normally greater than the value of its liquidated parts (Aoki et al., 1994, p. 18; Sheard, 1994, pp. 190–91). Thus, society as a whole benefits when potentially productive, but financially distressed, firms are rescued.[9] Efficient rescue prevents valuable firm-specific assets from being squandered by premature liquidation and avoids the costs associated with the coordination problems, conflicts of interest, and strategic behaviour that loom large in formal bankruptcies (Sheard, 1994, pp. 210–11). However, rescuing a firm is not always beneficial for society. Society suffers when financially distressed firms with no potential for future productivity are rescued. Propping up such firms wastes limited resources on preserving firm-specific assets that are of little value.

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[9] In the American system, the court-led bankruptcy system and the market for corporate control are seen to play the same role as main bank rescue. It is argued that, in the high-growth era, main bank monitoring did this more effectively than the American system and was a factor that contributed to Japan's higher growth. According to main bank theory, the main bank is in the optimal position to rescue because it does not suffer from the collective action and information asymmetry problems suffered by creditors, managers, and shareholders, and is less costly and has better information than the courts or corporate raiders (Sheard, 1994, pp. 210–11). Some corporate governance pundits incorrectly claim that in the post-bubble era hostile takeovers have played an important role in transforming Japanese corporate governance to be more like the American model (Puchniak, 2008). Ironically, despite such claims, it appears that the American system of corporate governance has been increasingly influenced by main bank monitoring over the last two decades (Puchniak, 2007c).

The implication for main banks is clear. To be efficient, they must have enough incentive to rescue potentially productive firms but not so much incentive that they indiscriminately rescue every firm – which of course would include those firms with no potential for productivity (Aoki, 2000, p. 83; 1994, pp. 126–8). According to the conventional main bank theory, the unique institutional environment that existed during Japan's high growth era (1951–73) produced such an equilibrium (Aoki, 2000, pp. 88–9; Aoki et al., 1994, p. 46).

To create the equilibrium, the government had to provide main banks with an incentive to rescue. As illustrated above, rescue is costly. Often, the costs associated with rescue exceed the losses that a main bank would suffer by forfeiting its debts. Micro-economic theory tells us that in such a situation rational bankers will jettison their clients – unwilling to throw good money after bad. This is especially true when the primary lender, such as the main bank, has an informational advantage over other lenders, making early exit feasible. Thus, the government had to provide substantial institutional rents – which are not provided by the free market – to give banks an incentive to rescue potentially profitable firms.[10]

The government created institutional rents by tightly controlling interest rates, restricting the bond market, and limiting new entrants to the banking industry (Aoki, 2000, p. 87; 1994, pp. 128–9). In this unique institutional environment, banks earned above-market rents from clients proportional to their share of deposits. To increase deposits, banks sought more branches. Since the government controlled new branches through issuing licences, it created an incentive for banks who kept their promise to rescue (Aoki, 2000, p. 87; 1994, p. 129).

There were also many legal and institutional deterrents that the government employed to ensure that main banks did not jettison their clients. The government had the power to withhold branch licences and dispatch ex-bureaucrats to banks which failed to fulfil their promise to rescue (Aoki, 2000, p. 87; Aoki et al., 1994, pp. 30–32). In addition, since the institutional environment made main bank rescue the norm, a main bank stood to suffer significant reputational losses by letting an inordinate number of firms fail. Specifically, if a main bank developed a reputation for jettisoning financially distressed clients, it stood to lose depositors (who would question the bank's ability to manage their funds), clients (who would doubt the bank's commitment to rescue), and business with other financial institutions (who might fear entering into a financing consortium with a bank prone to adverse selection) (Aoki, 2000, p. 87; 1994, pp. 129–30).

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[10] Aoki (2000, p. 86); Aoki et al. (1994, pp. 26–32); Sheard (1994, pp. 204–10); Ueda (1994, p. 89).

In sum, according to the conventional main bank theory, in the high-growth era, the cost of rescue combined with institutional rents and deterrents resulted in an equilibrium where banks had an incentive to rescue potentially productive firms (Aoki, 2000, pp. 82–9). Since main banks attempted to rescue potentially productive firms *ex post*, it made their promise to rescue credible *ex ante*. In addition, the high cost of rescue provided a strong incentive for main banks to avoid adverse selection by taking measures to lend to productive firms (*ex ante* monitoring) and by helping existing client firms to avoid financial difficulties (interim monitoring) (Aoki, 2000, pp. 79–89).

Most conventional main bank theorists suggest that Japan's institutional framework has irreversibly changed since the mid-1970s – reducing the institutional incentives that motivated main banks to rescue potentially productive firms.[11] The 1970s and 1980s saw the end of regulated interest rates, the phasing-out of restrictions on bonds, and the globalisation of markets (Aoki, 2000, pp. 89–90). This new institutional environment deprived main banks of the necessary rents to provide them with an incentive to rescue potentially productive firms (*ex post* monitoring) and to perform their other important *ex ante* and interim monitoring functions. The breakdown of the main bank system, of which efficient rescue was a critical part, is suggested by many scholars as a significant factor in the creation of the bubbles, their bursts, and the lost decade that followed (Aoki, 2000, pp. 89–92).

1.3 Japan's Unique Institutional Framework is at the Core of Rescue Theory

A core concept of main bank rescue theory, which cannot be overlooked, is the critical role played by Japan's unique institutional framework. This unique framework provided the incentives that drove the decision of banks to rescue potentially productive firms. Although much has been written about main bank rescue, at its core the theory is simple: for rescue to occur the incentive to rescue must be greater than the incentive not to rescue. As explained above, due to the high cost of rescue, it only became feasible when Japan's unique institutional framework provided the necessary incentives that made it in the best interest of main banks to do so.

In this sense, rescue theory is built on the notion that quantifiable incentives and rational decision making drive corporate governance. It leaves no room for vague notions of main bank managers choosing to rescue floundering firms on the basis of some nebulous concept such as *samurai* culture. Most main

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[11] Aoki (2000, pp. 89–92); Hoshi and Kashyap (2001, pp. 219–66); Gao (2001, p. 186).

bank theorists would agree with M&R that it is absurd to think that a sophisticated bank would voluntarily rescue a distressed client when the cost of rescue is greater than the potentially recoverable debt – that is, if it were not for institutional incentives. Thus, the core difference between the conventional main bank rescue theory and M&R's free-market theory is that institutional incentives matter in the former but not in the latter (Aoki, 1994, p. 131; 2000, pp. 86–9).[12]

2. PERVERSE MAIN BANK RESCUE IN THE LOST DECADE: PROOF THAT INSTITUTIONAL INCENTIVES MATTER

2.1 Rescuing Loser Firms: An Empirical Reality that Eludes M&R's Free-market Theory

Apply M&R's free-market theory to bank lending during the lost decade and the story told is a fairytale of neoclassical economics in practice. Japanese banks were motivated to maximise profits. As such, they withdrew credit from less profitable, poorly performing firms which were hurt by the collapse of the bubbles, and reallocated it to more profitable, well-performing firms. By doing so, the banks pressured poorly performing firms to adjust to changing market conditions or shut down. As a result, in the face of the dramatic asset devaluation, efficient banks did what they could to maximise profits and at the same time efficiently reallocated capital throughout the economy. Inefficient banks, which did not take such profit-maximising actions, were culled from the market and the firms they supported died. In the end, creative destruction occurred in banking and industry, credit was efficiently reallocated and the economy swiftly adjusted to continued growth.[13]

Like any fairytale, this one, based on M&R's free-market theory, remains a wishful fantasy. What should have been a fairytale of creative destruction was a long drawn-out recession punctuated by a banking nightmare. What should have been a banking crisis that was resolved in four years (when compared with other similar banking crises) lasted for well over a decade.[14] What should

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[12] For detailed evidence that M&R's free-market theory completely disregards even the smallest role for institutional incentives in Japan's post-war economy, see Puchniak (2007a, pp. 25–32).

[13] This description of how M&R's free-market theory would explain bank lending in the lost decade is consistent with the manner in which M&R describe firm performance in the lost decade (M&R, 2003, p. 24).

[14] In the 1990s, both Finland and Sweden went through more serious asset

have been a period of rampant creative destruction in a speculative banking industry (similar to what occurred in the US savings and loan and 1990s Nordic banking crises) was instead a period where the banking industry maintained its asset value.[15] The bill for the Japanese taxpayer, which should have been much less than the bill for American taxpayers to resolve their banking crisis after the relatively more severe Great Depression, ended up being for twice as much.[16] What should have been a decade where non-performing loans (NPLs) were written off was a decade that saw NPLs balloon.[17] It is clear that all of the things that 'should have happened', according to M&R's free-market theory, did not.[18] When economists became tired of examining the 'should haves' and began examining reality, the institutional framework that was maintaining Japan's uniquely costly and prolonged recession came into focus.

As the 1990s ended, it became increasingly clear that the bursting of the bubble and the economic stagnation that followed had not affected all industries equally. Industries such as real estate and construction – which expanded

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market collapses than Japan. Korean markets were also hit hard by the Asian currency crisis. In each case, as in Japan, the respective countries' banking systems had to deal with eroded healthy capital and massive amounts of non-performing loans. All of the countries resolved the fundamental problems in their banking systems in less than four years. This is consistent with comparative banking crisis research, which finds that the average banking crisis lasts for 3.9 years (Hosono and Sakuragawa, 2005, p. 2; Hutchison et al., 1999, p. 176; Hutchison and McDill, 1999, p. 156; 'Time to Arise from the Great Slump', *The Economist*, 22 July 2006, p. 71).

15 Japanese domestic banking assets shrank by less than 1 per cent between December 1993 and December 2003 – a stark contrast to the asset shrinkage that occurred in the US savings and loan industry, which shrank by 43 per cent between 1988 and 1993, the Finnish domestic banking system. which shrank by 33 per cent between 1991 and 1995, and the Swedish domestic banking system, which shrank by 11 per cent between 1991 and 1993 (Hoshi and Kashyap, 2004b, p. 23).

16 During the lost decade, Japan's worst annual growth rate was minus 2 per cent, whereas during the Great Depression, the United States suffered a negative growth rate of more than 6 per cent in each year between 1930 and 1932. By inference, one would expect that the banking crisis in the United States during the Great Depression was much more severe than the one in Japan during the lost decade. The opposite is true. During the Great Depression, the total amount lost by bank depositors was 2.2 per cent of GDP, whereas the cost to Japanese taxpayers of their banking crisis was 4 per cent of GDP. The Japanese government injected more than 10 trillion yen into the banking system with relatively little success (Hoshi and Kashyap, 2004a, pp. 4–6).

17 Astonishingly, over the course of the lost decade NPLs in Japan actually increased – despite massive injections of capital from the government (Hosono and Sakuragawa, 2005, p. 29).

18 'Dead Firms Walking', *The Economist*, 23 September 2004, pp. 77–8; Nishimura and Kawamoto, 2003, p. 302.

rapidly during the 1980s and relied heavily on the value of land – suffered far more during the lost decade than other industries such as manufacturing (Ahearne and Shinada, 2004, pp. 3–4). The significant losses suffered by hard-hit industries made bank loans to these troubled industries more risky and less profitable (Hosono and Sakuragawa, 2003, p. 1; 2005, p. 9). The obvious question that arose was whether Japanese banks were efficiently reallocating credit away from less profitable industries and towards the more profitable ones – as M&R's free-market theory would predict. The short answer is no. In fact, the opposite is true – they were systematically rescuing failing firms.

In the 1990s, Japanese banks increased lending to their clients that were least likely to pay them back and decreased lending to their clients that were most likely to pay them back.[19] Even more surprisingly, they did not charge a higher interest rate to their worst clients to compensate for increased risk.[20] As path dependence would predict, Japan's main banks took the lead in orchestrating the perverse scheme of systematically lending to loser firms (Puchniak, 2007a, pp. 57–9). Since M&R's free-market theory explicitly rejects the possibility that Japan's unique institutional framework drives the lending decisions of bank managers, one is left with the absurd conclusion that, for over a decade, Japanese bank managers systematically chose to *irrationally* 'spend good money after bad' to support unprofitable firms.

This chapter suggests a more rational theory based on a wealth of empirical and case study research.[21] Japanese bank managers *rationally* decided to

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[19] Puchniak (2007a, pp. 36–42); Peek and Rosengren (2005, pp. 1144, 1162–4); Hosono and Sakuragawa, (2005, pp. 8–9); Hosono and Sakuragawa (2003, pp. 1–2).

[20] Puchniak (2007a, p. 39); Caballero et al. (2006, pp. 5–12); Smith (2003); Sekine et al. (2003, p. 78); BIS Report (2002, pp. 133–4).

[21] There is overwhelming empirical evidence that during the lost decade Japanese banks systematically lent to inefficient and unprofitable firms (Puchniak, 2007a, pp. 36–9). More importantly, the evidence is clear that institutional incentives motivated the decision to lend to losers – not profit maximisation (Hosono and Sakuragawa, 2003, p. 19). There are four empirical findings related to bank lending in the lost decade, which have been confirmed by numerous scholars, that support this conclusion: (1) banks disproportionately increased lending to unprofitable industries; (2) banks disproportionately increased lending to firms with lower profit rates and poor share returns; (3) the future performance of firms that received additional loans was worse than average; and (4) banks increased lending to firms at below-market interest rates (Puchniak, 2007a, pp. 37–9). These empirical findings are also supported by a wealth of case study evidence. It may be possible to stretch M&R's free-market theory to make sense out of some of the empirical research and perhaps even a few case studies (Puchniak, 2007a, 37–42). However, M&R's free-market theory is ill-equipped to provide a workable explanation for the evidence as a whole. In light of the weight of the evidence, even M&R may be bashful to conclude that, since lending to losers does not accord with free-market theory, the best explanation is that lending to losers did not happen at all.

lend to their worst clients because Japan's unique institutional framework gave them an incentive to do so. The unique institutional framework that made it a rational decision for Japanese bank managers to systematically make such seemingly irrational decisions, involving trillions of yen, for over a decade, is explained below.

2.2 The Institutional Framework in the Lost Decade: the Incentives that Drove Main Bank Rescue

During the lost decade an institutional framework emerged that provided incentives that drove banks to systematically lend to losers. Under this institutional framework, profit-maximisation and efficiency took a back seat to bank managers motivated by survival to keep banks open and, more importantly, ensure their lifetime employment at all costs. Indeed, normally making a profit is the best way to ensure firm survival – that is, unless a firm does not have a realistic chance of actually making a profit, in which case *appearing* to make a profit is the next best option.

There are several ways that a firm can go about creating the false perception that it is making a profit. However, most methods are either criminal or short-term strategies, at best. For Japanese banks, to decide that creating the appearance of profits was a viable long-term strategy, when trillions of yen were at stake, sounds more like an act of *hara-kiri* than a rational management strategy. Unless, of course, there was government help. And help the government did.

Luckily for the fledgling banks, the Japanese government had political motives that aligned with their survival agenda. The government was in no position to see large inefficient banks and/or unprofitable firms go under on a grand scale.[22] Thus, political realities, not economics, drove the creation of an institutional framework that allowed banks to select lending to losers as a viable long-term strategy (in many cases, the *only* strategy) for survival. In retrospect, three watershed events sparked the emergence of the perverse, institutionally driven equilibrium of lending to losers in the lost decade.

First, in the early 1990s, the bubble burst. The collapse of the real estate and stock markets significantly eroded healthy bank capital. Losses were magnified by the fact that Japanese banks, in contrast to their American and English counterparts, relied extensively on real estate to collateralise loans and held significant share portfolios (Tett, 2004, p. 62). The battered stock markets also made it extremely difficult for banks to issue equities to raise much needed

[22] Caballero et al. (2006, p. 2); Peek and Rosengren (2005); Tett (2004, pp. 68–9).

new capital. This shifted the focus of bank managers from expanding market share to retrenching and ensuring bank survival.

Second, in fiscal year 1992, the risk-based capital standards based on the 1988 Basel Capital Accord ('the Basel Accord') came into force.[23] The Basel Accord required that the ratio of capital to risk-weighted assets (the RBC (risk-based capital) ratio) held by Japanese banks not fall below a certain level (Montgomery, 2005, p. 25; Ito and Sasaki, 2002, pp. 373–4). Although there are no explicit penalties in the Basel Accord for falling below the RBC ratio, achieving it was viewed as a must for banks.[24] Failing to achieve the required ratio can result in the Financial Services Agency (FSA) taking control of the bank, international regulators curtailing overseas operations, and market discipline (Watanabe, 2006, p. 3; Ito and Sasaki, 2002, pp. 373–4). The incentive for a Japanese bank manager to avoid such consequences is clear: ensure the bank meets the minimum capital requirement or lose lifetime employment (Hosono and Sakuragawa, 2003, pp. 3-4; 2005, p. 4).

Third, as the decade progressed and Japan's NPL problem materialised, market participants began to regard ratios of NPLs of Japanese banks as an important indicator of bank health. Banks that failed to keep NPLs in check were quickly punished by an increasingly sceptical market and seen as prime candidates for mergers or FSA intervention (Fukuda et al., 2005, p. 7). For bank managers, this meant that keeping the NPL ratio down was as important as meeting the minimum RBC ratio; this objective had to take priority over all others, including profits.

Considered together, the incentives for Japanese bank managers in the lost decade were straightforward: remain solvent, stay above the minimum RBC ratio, and keep NPLs down, or lose their jobs. However, exactly how bank managers were to achieve these objectives proved to be more complex.

Bank managers were not making their decisions in a game theory model played out in a Tokyo University or Harvard laboratory. They had to pragmatically determine which actions would have the highest chance of achieving their objectives on the basis of the implementation of the Basel Accord, Japan's unique regulatory and accounting practices, institutional pressures, and bank finances. What complicated the decision for bank managers even more was that actually achieving their objectives was, in many cases, extremely unlikely and, in some cases, virtually impossible (Hoshi and Kashyap, 2004a, pp. 16–18; Peek and Rosengren, 2005, pp. 1144–5). With an

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[23] Though the Basel Accord was agreed upon in 1988, the capital standards became effective in Japan from fiscal year 1992 – after a five-year transition period (Montgomery, 2005, p. 25; Ito and Sasaki, 2002, p. 373).

[24] Watanabe (2006, p. 3); Hosono and Sakuragawa (2003, pp. 3–4); Ito and Sasaki (2002, pp. 373–4).

institutional framework that facilitated and encouraged creating the façade of profitability, it became rational for bank managers to aim for the more attainable objective of *appearing* to achieve their objectives rather than the unlikely possibility of *actually* achieving them. Indeed, the pay-off of continued lifetime employment for bank managers was the same for both.

As the empirical and case study evidence demonstrates, the optimal strategy for most Japanese bank managers was to continue to lend to loser firms to keep them from defaulting on their loans – a practice referred to as 'evergreening'.[25] By systematically practising evergreening, bank managers achieved all of their objectives. This is because in Japan's unique institutional environment evergreening made it appear to outsiders as if banks (1) were solvent; (2) had RBC ratios above the minimum requirement; and (3) were keeping their NPLs in check. The remainder of this section will explain how Japan's unique institutional framework ensured that evergreening bank managers would achieve these results.

2.3 Japan's Unique 'Enforcement' of the Basel Accord: an Incentive to Evergreen

As mentioned above, in fiscal year 1992, the Basel Accord went into force in Japan (Montgomery, 2005, p. 25). Internationally, the objective of the Basel Accord was to standardise capital requirements for banks around the world in order to make the international banking system more resilient to adverse market shocks (Ito and Sasaki, 2002, p. 373). From the standpoint of Japanese banks, the timing of the Basel Accord coming into force in Japan could not have been worse. Meeting the minimum capital requirements set out in the Basel Accord appeared easily attainable at the time Japan entered into the accord – before the stock market bubble burst (Puchniak, 2007a, n. 152). Post-burst, the story was very different and the Japanese government and banks were forced to 'cooperate' and devise a scheme to make it appear as if the minimum capital requirements in the Basel Accord were being met by Japanese banks. To understand the effect of the Basel Accord and the response to it from the Japanese government and banks calls for some elementary mathematics.

The primary requirement of the Basel Accord is that banks in member states must maintain a certain amount of healthy capital in proportion to their risky assets – which is called the RBC ratio (Montgomery, 2005, p. 25; Ito and Sasaki, 2002, pp. 373–4). The Basel Accord defines the RBC ratio as capital

[25] Hosono and Sakuragawa (2003, pp. 2–6; 2005, pp. 8–9); Peek and Rosengren (2005).

divided by risk-weighted assets. The Basel Accord requires internationally active Japanese banks to maintain an RBC ratio of at least 8 per cent.[26]

Capital, the numerator of the RBC ratio, consists of tier I (or core) capital and tier II (or supplementary) capital. Tier I capital is composed of share issues and disclosed reserves, including share premiums and retained earnings. Tier II capital is composed of undisclosed reserves, including unrealised capital gains on securities, provisions for general loan losses and subordinate debt with maturities exceeding five years. Tier II capital cannot exceed tier I capital in its contribution to total capital (Hosono and Sakuragawa, 2005, p. 6).

Risk-weighted assets, the denominator of the RBC ratio, is composed of bank assets which are weighted according to their degree of risk. Risky assets such as loans receive a 100 per cent weighting and riskless assets such as government bonds receive a 0 per cent weighting. Secured loans, which are seen as moderately risky, fall in between with a weighting of 50 per cent (Montgomery, 2005, p. 25).

Arithmetically, the choice that bank managers have to increase the RBC ratio is limited. They can either increase capital (the numerator) by issuing new equities, subordinate debts, or preferred shares, or by increasing general loan loss reserves; or they can decrease risk-weighted assets (the denominator) by reducing heavily weighted assets such as loans or equity holdings and substituting them with safe assets such as government bonds.

The rationale for compelling banks to meet the RBC ratio is to force banks, especially weak banks, to decrease their overall risk so that they can more easily withstand market shocks. The drafters of the Basel Accord believed that the RBC ratio would achieve this by compelling banks with low RBC ratios to increase tier I and tier II capital and/or decrease risky assets. Indeed, banks around the world have largely acted as the drafters of the Basel Accord intended (Jones, 2000, p. 36).

In fact, if anything, history has shown that the RBC ratio has worked too well in making banks stable and, in some cases, has made them risk-averse (Jones, 2000, p. 36; Watanabe, 2007, p. 642). Normally, it is difficult and costly for weak banks to raise new capital (the numerator in the RBC ratio). Consequently weak banks that are at risk of falling below the RBC ratio have resorted to shifting assets from loans (100 per cent weighted) to riskless assets such as government bonds (0 per cent weighted) – thereby decreasing the denominator of the RBC ratio – while at the same time cutting commercial lending (Watanabe, 2007, pp. 642–3; Jones, 2000, p. 36). In the early 1990s, when the United States was in the midst of a recession, many blamed the RBC

[26] Banks that are not internationally active are allowed, under the Accord, to maintain an RBC ratio of at least 4 per cent (Montgomery, 2005, p. 25).

ratio for driving banks to indiscriminately cut commercial lending, causing a phenomenon that became known as a 'capital crunch' (Hall, 1993; Haubrich and Wachtel, 1993). The 'capital crunch' in the United States, during the early 1990s, is suggested by many academics as a major factor in deepening the recession in the United States at that time (Hall, 1993; Haubrich and Wachtel, 1993). Even considering American critiques of the Basel Accord, the conventional wisdom is that the RBC ratio drives banks to decrease risk – if anything, too much.

However, during Japan's lost decade, bank managers did not respond as the drafters of the Basel Accord, American precedent, or M&R's free-market theory would predict (Puchniak, 2007a, n. 166). Japanese banks found themselves in the unique position where government regulations and incentives, coupled with their battered balance sheets, made evergreening, rather than cutting risky loans, a more effective strategy for meeting the RBC ratio.[27] Conveniently, this strategy also meant that NPLs would not be reported – an effective way of keeping the NPL ratio down.

From an accounting perspective, it is easy to explain how evergreening creates the façade that a bank is meeting its RBC ratio. When a poorly performing firm is unable to pay the interest on its loan for a certain length of time (three months since March 1998, and six months previously), the loan becomes non-performing (Jackson and Lodge, 2000, p. 111). The NPL first appears on a bank's financial records as a loan loss reserve (a liability contra-asset account) on a bank's balance sheet before being written off. If the bank's income is low and/or the level of NPLs is high, its loan loss reserve charge may exceed its income. This requires the bank to reduce its book capital (Dewenter and Hess, 2003, pp. 12–13). During the lost decade, as banks suffered from massive amounts of NPLs and low incomes, when a bank wanted to call in its NPLs it normally had to write off existing capital, which in turn pushed the bank up against the minimum RBC ratio requirement (Caballero et al., 2006, p. 2).

In theory, to avoid this result is simple. Before a poorly performing firm's loan becomes non-performing, the bank can evergreen by lending the firm enough funds to pay the interest on its loan. This kills two birds with one stone – it keeps the loan 'performing' and the *reported* RBC ratio from falling (Sekine et al., 2003, p. 71). During the lost decade, Japan's ultra-low interest rates made this a relatively inexpensive strategy (Caballero et al., 2006, pp. 6–7).

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[27] Hosono and Sakuragawa (2003, pp. 3–6); 'Don't Feed the Zombies', *The Economist*, 8 April 2006, p. 58.

Regardless of how low interest rates are, evergreening is a Ponzi scheme that free-market forces normally rout out (Dewenter and Hess, 2003, p. 13). As poorly performing firms continue to underperform, they require more bank loans both to continue their inefficient operations and to cover their interest payments, causing risky assets (the denominator in the RBC ratio) to increase. At the same time, evergreening banks are deprived of real interest income, which eventually will cause capital (the numerator in the RBC ratio) to fall. When the market becomes aware of evergreening, raising new capital becomes next to impossible and bank-financing charges rise, which further impairs capital. Thus, under normal free-market conditions, which M&R's theory assumes, evergreening is not a viable option, because it merely delays capital erosion in the short term and ultimately inflates capital losses when market forces compel disclosure or drives the firm to bankruptcy – that is, without government help.

During the lost decade, the Japanese government created an institutional framework that allowed banks with significant NPLs and insufficient healthy capital to use evergreening as a long-term strategy.[28] The government ensured that free-market forces would not come to bear on evergreening banks by creating a matrix of laws, regulations, policies, and direct government funding to maintain evergreening and the façade that it helped create. The institutional framework neutralised market forces by: (1) artificially inflating bank capital by creating and sanctioning accounting gimmicks; (2) preventing disclosure of evergreening by implementing a forbearance regulatory policy; (3) ensuring bank management that evergreening would not result in bankruptcy; and (4) providing capital at below-market interest rates.

This seems like a lot of effort for a government to maintain a façade – it was. But for the government, the political incentives loomed large. With a mushrooming budget deficit[29] and a voting public that was weary of funding bank bail outs and were fearful of increasing unemployment, the government could ill afford the political fallout of major banks or large loser firms failing on a grand scale.[30] Thus, political motives, which are not governed by standard economic theory, drove the creation of the institutional framework that supported evergreening.

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[28] Peek and Rosengren (2005, pp. 1144–5); Hosono and Sakuragawa (2003, pp. 2–6); Caballero et al. (2006, p. 2).

[29] 'The Viagra Economy', *The Economist*, 24 September 2005, p. 12; Tett (2004, p. xxiv); 'Chronic Sickness', *The Economist*, 2 June 2001, p. 73.

[30] Peek and Rosengren (2005, p. 1145); Fukao (2002, p. 3); Caballero et al. (2006, pp. 2–3).

2.4 Government Accounting Gimmicks Facilitated Evergreening

During the lost decade, the government created and sanctioned numerous accounting gimmicks that prevented free-market forces from disciplining evergreening banks. Accounting regulations were implemented to artificially inflate banks' regulatory capital, which made it possible for banks to carry on evergreening as a long-term, as opposed to short-term, strategy (Hosono and Sakuragawa, 2003, p. 3). The most effective government-orchestrated accounting gimmicks were: (1) to manipulate fair-value and historical-cost accounting standards to suit market fluctuations; (2) to allow double gearing with insurance companies; and (3) to permit massive amounts of deferred taxes to count as capital.

The historical account of how the Japanese government manipulated fair-value and historical-cost accounting standards to inflate banks' regulatory capital is laughable. The government's manipulation started in the early 1990s, when the stock market bubble burst but share prices were still relatively high. At this time, the government determined that the best way to help banks increase their capital was to allow them to apply fair-value accounting standards to their securities (that is, to take advantage of the rise in share values) which produced large latent capital gains. Such manipulation would have had no effect on the regulatory capital of banks in most other countries because latent capital gains are generally prohibited from being counted as part of regulatory capital.[31] Despite this, in 1991, the Ministry of Finance (MoF) allowed Japanese banks to include 45 per cent of their latent capital gains generated from the application of fair-value accounting as part of tier II regulatory capital. And so, just like that, the regulatory capital of Japanese banks ballooned overnight. Real capital and banking risk, of course, were left unchanged.

Then, in 1997, when share prices dropped sharply, and fair-value accounting no longer resulted in inflated regulatory capital, the MoF reversed its position. Now, conveniently for Japanese banks, the MoF allowed historical-cost accounting to be used so that the value of shares could be counted at their acquisition price. This allowed the banks to avoid the unrealised capital losses that would have decreased their regulatory capital (Hosono and Sakuragawa, 2005, p. 7). To add to the façade, at the very same time, the MoF allowed banks to use fair-market accounting to value land. Predictably, this resulted in increasing banks' regulatory capital because most banks acquired a large proportion of their land long before it appreciated in the late 1980s (Hosono

[31] For example, in the United Kingdom and United States, banks are prohibited from including capital gains in regulatory capital (Ito and Sasaki, 2002, p. 374).

and Sakuragawa, 2005, p. 7). The result was that large unrealised capital gains from land holdings could be included in tier II capital. Again, overnight-reported regulatory capital ballooned. And again, such gimmicks left the actual capital and stability of evergreening banks unchanged.

Another accounting gimmick that was allowed by the government to help protect evergreening banks from market forces by artificially inflating regulatory capital was 'double gearing' (Hoshi and Kashyap, 2004a, pp. 18–19; Hosono and Sakuragawa, 2005, pp. 6–7). In the most popular form of double gearing, banks issued subordinate debt (which increases tier II capital) to *keiretsu*-affiliated life insurance companies. This allowed the banks to raise cash and then use that cash to buy subordinate debt issued by the life insurance companies, so that the life insurance companies could then buy the subordinate debt that was issued by banks to raise cash in the first place (Hoshi and Kashyap, 2004b, p. 3). To the credit of Japanese banks, they mastered the twisted art of double gearing during the lost decade and, in the process, created trillions of yen of bogus capital.[32]

Is double gearing an accepted international practice? Of course not. The international norm is that domestic regulators prohibit double gearing (Hoshi and Kashyap, 2004a, p. 19). The international financial community criticised Japanese regulators when the practice of double gearing was eventually revealed (BIS Report, 2002, p. 135). Despite this, in 2000, when Chiyoda Life failed and Tokai Bank lost 74 billion yen, the FSA actively encouraged double gearing. Curiously, Shokichi Takagi, the Director of the FSA's Supervision Department, publicly stated that double gearing among financial institutions is highly beneficial to enhance public confidence – a statement that only makes sense after a double shot of *shochu* (Fukao, 2002, pp. 2–3).

In 1999, a year after a few Japanese banks collapsed, regulators desperately scrambled to devise yet another plan to maintain the façade that the banking system was healthy in order to ensure that evergreening continued. The new gimmick was to count deferred taxes (that is, tax credits from past losses that the bank expected to claim in the future) as tier I capital. This was a boon for evergreening banks because, once again, it caused artificially inflated regulatory capital to balloon.

According to Japanese tax law, deferred taxes expire five years after losses are incurred. This means that if poorly performing banks do not become profitable the deferred taxes are worthless. As capital is supposed to serve as a buffer for unexpected losses, it does not make sense – aside from artificially

[32] In March 2001, as the lost decade was coming to an end, life insurance companies held 10.5 trillion yen of subordinated debt issued by banks, while banks held 2.0 trillion yen of subordinated debt issued by life insurance companies (Hoshi and Kashyap, 2004a, p. 19).

inflating regulatory capital – to count deferred taxes as part of regulatory capital, because they are useless precisely when the buffer is needed (Hoshi and Kashyap, 2004a, p. 15; BIS Report, 2002, p. 133). For this reason, in the United States, regulators limit deferred tax assets to 10 per cent of tier I capital. However, and somewhat predictably, in Japan there was no such limit. In March 2003, deferred taxes accounted for a whopping 40 per cent of Japanese banks' book value capital (Hoshi and Kashyap, 2004a, pp. 16–17).

The net result of government-sanctioned accounting gimmicks is that, during the lost decade, banks' RBC ratios considerably diverged from actual capital ratios (Hosono and Sakuragawa, 2005, p. 7). Several sources confirm that, as the lost decade progressed, years of accounting gimmicks caused actual bank capital to be a mere fraction of the reported regulatory capital.[33] A striking example can be seen in the reported RBC ratios of Hokkaido Takushoku Bank and the Long-Term Credit Bank of Japan in 1997. At that time, both banks had reported RBC ratios above the minimum 8 per cent. Two years later, both banks were bankrupt (Hosono and Sakuragawa, 2003, pp. 21–2; Tett, 2004, p. 105). The government's ability to artificially inflate the RBC ratios of banks allowed evergreening to continue unchecked. In this sense, evergreening was driven by Japan's unique institutional framework. M&R's free-market theory fails to explain these facts.

2.5 Regulators Turning a Blind Eye Made Evergreening Feasible

The Japanese government's forbearance policy was carried out by regulators who turned a blind eye to evergreening – allowing evergreening banks to avoid free-market pressures (Caballero et al., 2006, p. 2). Throughout the lost decade, regulators misclassified loans as sound when they were clearly troubled and non-performing. This allowed banks to continue evergreening by understating their non-performing loans and to avoid making adequate loan loss provisions, which artificially inflated regulatory capital.[34]

The lost decade is full of evidence of regulatory blindness (Hoshi and Kashyap, 2004b, p. 19). A study by the *Nikkei* newspaper found that nearly 75 per cent of loans to Japanese firms that declared bankruptcy in 2000 had been classified as sound or merely in need of monitoring.[35] Similarly, the put

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[33] 'Nationalized Once, Nationalized Again?', *The Economist*, 6 July 2002, p. 71; Dvorak, P., 'Japan's Banks Face Debate on What Counts as Capital', *Wall Street Journal*, 20 November 2001, p. C1.

[34] There is evidence that the government phased out its forbearance policy in the late 1990s and early 2000s, which was a driving force behind Japan's extraordinary recent economic recovery between 2002 and 2006 (Puchniak, 2008).

[35] 'Mere Fiddling', *The Economist*, 30 June 2001, p. 69.

options granted to Shinsei and Azzora associated with the purchase of supposedly cleaned-up banks were awarded to the buyers of the failed banks because the government prevented the bidders from inspecting the banks' books. The government's idiosyncratic bidding system was created because it feared that if bidders could inspect the banks' books, evergreening would be exposed and other banks evergreening the same underperforming borrowers would be forced to come clean.[36]

The complicity of regulators with evergreening banks curbed the ability of market forces to discipline Japan's bank managers. In this way, the government's political concerns altered the result that would have been achieved in M&R's utopian Japanese free market (Peek and Rosengren, 2005, p. 1165). This allowed bank evergreening to continue on a massive scale for over a decade despite its negative impact on the profitability of banks and the massive misallocation of credit in an economy that is heavily reliant on private debt.

2.6 Government Insurance Buffered Evergreening Banks from Free-market Forces

Another mechanism the government used to allow banks to continue evergreening was to assure banks that they would not fail and to guarantee bank deposits. Until the late 1990s, it was widely accepted that the Japanese government would not let banks fail, especially large banks. This allowed bank managers to continue to engage in evergreening with the assurance that if the Ponzi scheme eventually did collapse, the government would be there to catch them (Hosono and Sakuragawa, 2003, p. 6).

In the late 1990s, when it appeared that some market discipline might come to bear on evergreening banks – as the 'no-fail policy' was threatened by the collapse of Hokkaido Takushoku Bank (and Sanyo and Yamaichi in the securities industry) – the government reformed the Deposit Insurance Act. In 1996, the Act was amended, lifting the existing 10 million yen limit on deposit insurance so that all deposits were covered. The limit was supposed to be reintroduced on 1 April 2001 but was postponed until 1 April 2002. Non-interest-bearing loans remained fully protected until 1 April 2005 (Hoshi and Kashyap, 2004b, p. 19). This allowed banks to continue to attract cheap capital in the form of deposit accounts, while engaging in inefficient profit-reducing behaviours such as evergreening (Hoshi and Kashyap, 2004a, p. 9; 2004b, p. 19).

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[36] 'Reborn, Remade, Resold', *The Economist*, 17 January, 2004, p. 64.

2.7 When All Else Failed, Taxpayers' Money Was Used to Help Banks Evergreen

When all else failed, the government simply pumped taxpayers' money into the banks so that they could use it to evergreen (Hosono and Sakuragawa, 2005, pp. 28–9). By some accounts, in 1998 and 1999, almost one half of the public funds injected into the banking system were passed on to troubled construction companies in the form of debt forgiveness.[37]

The government did not merely turn a blind eye to mass evergreening with taxpayers' funds – it pressured banks to do it. The FSA exerted severe pressure on foreign-owned Shinsei Bank (widely regarded as the only bank in Japan that has seriously applied credit risk analysis in its lending decisions) to continue lending to severely troubled firms (Tett, 2004, pp. 227–37). Specifically, when Shinsei Bank was deemed to be 'behaving improperly' by pulling loans from troubled firms, the FSA warned Shinsei that it was government policy for banks to support category two (deeply troubled but operating) firms regardless of how risky they might be.[38] Category two firms, which have come to be known as 'zombies', were typically firms kept alive by evergreening and accounted for the bulk of Japan's NPLs (Tett, 2004, p. 234).

When the government could not pump taxpayers' money into evergreening banks directly, it did so indirectly. From 1990, when the MoF changed its regulations to allow banks to issue subordinated debts to raise their capital ratios, the government subsidised banks by purchasing subordinate debt at below-market levels (Hosono and Sakuragawa, 2005, p. 8; 2003, p. 15). Subordinate debt, if fairly priced in the market, can act as a disciplining mechanism on unprofitable banks. However, subordinate debt was not fairly priced to reflect banks' default risk, as the purchasers were most often associated life insurance companies and the government, who never sold the debt in the market (Hosono and Sakuragawa, 2005, p. 8; 2003, p. 15). The government often repaid subordinated debt holders on behalf of insolvent banks, thereby removing risk-based pricing from the market (Hosono and Sakuragawa, 2005, p. 8). These observations suggest that subordinate debt did not play any disciplinary role but was used as another mechanism to allow evergreening to continue (Hosono and Sakuragawa, 2005, p. 8; 2003, p. 15).

The government's direct and indirect use of taxpayers' money to fund evergreening turned what started out as a bank-based Ponzi scheme into a national Ponzi scheme. It dragged out the recession for over a decade. In the process,

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[37] Tett, G. and D. Ibison, 'Tokyo May Have to Support Banks', *Financial Times*, 14 September 2001, p. 3.

[38] Tett (2004, pp. 233–7); Singer, J. and P. Dvorak, 'Shinsei Bank Pressured to Keep Shaky Loans', *Wall Street Journal*, 26 September 2001, p. C1.

the government accumulated unfathomable deficits unmatched by any other OECD country (Hoshi and Kashyap, 2004a, pp. 16–18). M&R's free-market theory would have predicted none of this.

2.8 Empirical Evidence Confirms That the Institutional Framework Drives Evergreening

As if all of the aforementioned evidence is not enough, there is now empirical evidence that directly supports the hypothesis that evergreening is driven by Japan's unique institutional framework. Hosono and Sakuragawa, in their recent paper, examine the relationship between the government allowing the use of accounting gimmicks to artificially inflate regulatory capital (which they call 'accounting discretion') and evergreening (Hosono and Sakuragawa, 2005, pp. 8–9). From a number of statistically significant results, which demonstrate the relationship between accounting discretion and evergreening, they arrive at a definitive conclusion:

> Severely capital-constrained Japanese banks, particularly major banks, extended bad loans in order to inflate regulatory capital under the accounting rule, which allowed banks to hide latent loan losses. The government responded to the perverse behaviour of banks by allowing the discretionary enforcement of minimum capital requirements which softened the banks' capital constraints and contributed to the increase in bad loans. (Hosono and Sakuragawa, 2005, p. 28)

Enough already. The point is simple: self-interested bank managers lent to loser firms to meet regulatory requirements so that they could keep their life-time employment – not to make banks more profitable. Self-interested Japanese government officials facilitated this behaviour to avoid the political repercussions of massive bank and industry failures. The effect of free-market forces was *de minimis*. This is the opposite to that which M&R's theory would predict.

2.9 The Main Bank System Shaped Evergreening in the Lost Decade

As powerful as Japan's government was, the main bank system also played an indispensable role in driving banks to evergreen. In fact, empirical evidence suggests that without the main bank system in place the government's ability to persuade banks to evergreen would have been extremely limited (Peek and Rosengren, 2005, p. 1144). The main bank system, developed after the war, was the most important factor in determining which banks evergreened and to whom.

From the perspective of the conventional main bank theory, evergreening makes perfect sense – it is merely conventional rescue theory gone bad. As

explained in Section 1 above, rescue theory is based on the premise that banks promise to rescue because the institutional framework provides the necessary incentives to make rescuing in the best interest of banks. As the theory goes, in the high-growth era, the government provided an optimal level of incentives to drive banks to an efficient equilibrium where they only rescued potentially productive firms.

Similarly, in the lost decade, the institutional framework created by the government (and not free-market forces) drove rescue behaviour. However, the incentives provided by the government were not to rescue only potentially productive firms but, perversely, to rescue habitually unproductive firms to achieve a political agenda. In other words, the same mechanism that drove efficient rescue ultimately drove evergreening – the only difference was that the level of incentives provided by the government to rescue were much greater and the agenda was different.

Peek and Rosengren, in their recent research, conclude that during the lost decade the main bank system played an integral role in facilitating evergreening. They find, using a host of empirical measures, that main banks were more likely than secondary banks or other lenders to provide additional loans to failing firms (that is, to evergreen) and that this effect was even stronger if the firm was in the same *keiretsu* (Peek and Rosengren, 2005, p. 1161).

Peek and Rosengren's research also suggests that the government specifically encouraged main banks, as opposed to other lenders, to fulfil their traditional role as 'the rescuer' by evergreening failing firms. They find that government lenders were more likely to increase loans to firms that had troubled main banks. This suggests that the government attempted to aid unhealthy main banks that were keeping their promise to evergreen (Peek and Rosengren, 2005, p. 1162).

The only group for which Peek and Rosengren were unable to confirm a pattern of evergreening in the lost decade was non-bank lenders that were not in the same *keiretsu* as the borrowing firm (Peek and Rosengren, 2005, p. 1162). This makes perfect sense, as these firms were not driven by either government-created incentives (which were specifically directed towards banks) or incentives that were provided to main banks to rescue failing client firms.

Miwa and Ramseyer's free-market theory appears even more untenable in light of the evidence of a link between evergreening and the main bank system. In Japan's post-bubble era, which is often described as the most deregulated period in post-war Japan, M&R's free-market theory should shine. Yet it completely misses the mark. The supposed 'mythical main bank system', which M&R claim is a 'figment of the academic imagination', is central to understanding the reality of post-bubble corporate Japan. The actions of main bank managers, who held the reins of control over corporate Japan throughout the lost decade, appear illogical without an understanding of institutional

incentives – which according to M&R's theory are insignificant in Japan's perfect free market.

The fact that M&R's theory fails to explain the reality of Japanese corporate governance should not surprise. It would be astounding for a simple theory based on the lone assumption of free markets to explain the complex interaction between Japan's unique institutional framework (that is, its matrix of laws, regulations, institutions and formal and informal government policies and practices) and one of the most complex economies in the world. Unfortunately, the world is not as simple as M&R's theory suggests. To assume that it is so simple leads us to erroneous conclusions. Indeed, according to M&R, 'the moral is simple: the main bank does not help the least profitable firms. If anything, it avoids them' (M&R, 2003, p. 22). It would be difficult to construct a less accurate description of main bank lending in Japan's post-bubble era.

3. BANK LENDING IN THE LOST DECADE: EVIDENCE OF MAIN BANKS' SIGNIFICANCE IN THE POST-BUBBLE ERA

The lost decade is often characterised as an era in which the main bank system had a diminished impact on Japanese corporate governance. According to M&R's free market theory, the decline of main bank influence during the lost decade would make sense. In a perfect free market, banks that systematically lend to their worst clients at below-market interest rates will be culled from the market. If the banking industry as a whole carries on such inefficient lending, it will be 'creatively destroyed' and replaced by other methods of financing such as public debt. Indeed, such 'creative destruction' caused the US savings and loan industry to shrink by 43 per cent after its inefficiencies were revealed in the late 1980s and the Nordic banking industries to shrink by up to 33 per cent after the Nordic banking crisis in the early 1990s (Hoshi and Kashyap, 2004b, p. 23).

Contrary to what M&R's theory and other precedents predict, the influence of Japan's main bank system did not decline as a result of perverse lending in the lost decade.[39] In fact, the opposite happened. As a result of the institutional

[39] Japan's main bank system did not experience 'creative destruction' as did the inefficient banking industries in the US and Nordic countries. Japanese domestic banking assets shrank by the marginal amount of less than 1 per cent between December 1993 and December 2003. This is astonishing considering that by 2003 the government had let a number of banks fail and was beginning to reverse its policy of supporting evergreening (Puchniak, 2008).

incentives that shielded main banks from free-market forces, the main bank system dramatically increased its influence over the Japanese economy throughout the lost decade.

In 1990, at the beginning of the lost decade, 28 per cent of Japan's largest listed companies relied exclusively on banks for their financing. By the early 2000s, the percentage of Japan's largest firms that relied exclusively on banks for financing rose to almost 47 per cent. Throughout the lost decade over 85 per cent of Japan's largest listed companies relied on some level of bank financing (Arikawa and Miyajima, 2007, pp. 54–5). The increasing influence of banks during the lost decade is further confirmed by the finding that the ratio of bank borrowing to total debt in corporate Japan consistently increased throughout the lost decade to ratios unseen since the mid-1980s (Arikawa and Miyajima, 2007, p. 56). The dramatic increase in the reliance of Japan's largest listed companies on bank lending during the lost decade is astounding considering that Japan's largest listed companies had access to a newly deregulated bond market.[40]

The increasing influence of the main bank system on Japanese corporate governance throughout the lost decade runs even deeper. A number of empirical studies find that, although the dependence of Japanese companies on bank lending generally increased throughout the lost decade, the increase was predominately the result of a more dramatic increase in lending by main banks to their long-term clients in underperforming industries. In fact, empirical evidence suggests that Japan's most profitable large companies may have moved away from their reliance on main bank lending throughout the lost decade (Arikawa and Miyajima, 2007, pp. 54–62). The most important role for a system of corporate governance is efficiently replacing management and driving restructuring in underperforming companies. The empirical evidence that main banks played an increasingly critical role in such companies throughout the lost decade further confirms the increasing significance of the main bank system in the post-bubble era.[41]

Admittedly, an interesting question remains as to whether the cost to Japanese taxpayers of maintaining the perverse main bank system during the

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[40] In January 1996, Japan finally finished phasing out all of its regulatory restrictions on public debt (Arikawa and Miyajima, 2007, p. 52).

[41] In addition, despite the unwinding of cross-shareholding in the lost decade, main banks chose not to unwind shares of their weakest clients (Miyajima and Kuroki, 2007, pp. 102–106). Based on a number of empirically significant findings, Miyajima and Kuroki conclude that during the lost decade main banks refrained from selling their cross-shareholdings in long-term client firms and that the decision of banks to sell their cross-shareholdings 'was based more on the nature of their financial relationship than on the credit risk of those firms' (Miyajima and Kuroki, 2007, p. 102).

lost decade was worth the relative advantage of the social stability that it probably provided (Puchniak, 2008). This chapter does not address this question. However, there is strong evidence that the main bank system (and not an 'Americanized' system of Japanese corporate governance) played a critical role in driving the recent recovery since 2002 (Puchniak, 2007c; 2008). This suggests that the government's efforts to maintain the main bank system throughout the lost decade were not in vain.

Rather than attempting to address such ambitious questions about the normative impact of perverse lending in the lost decade, this chapter has sought to address a more humble question: did Japan's institutionally driven main bank system continue to play a significant role in the post-bubble era? Evidence of institutionally driven perverse main bank lending throughout the lost decade and the increasing level of dependence on main banks (especially in Japan's underperforming industries) demonstrates that Japan's institutionally driven main bank system continued to play a significant role in the post-bubble era. This further proves that M&R's claim that the main bank system is 'a myth' is false.

Before concluding this analysis, I must make a final point. There is now strong evidence that aspects of Japan's main bank system have developed in the United States (Puchniak, 2007c, pp. 44–8). This demonstrates that M&R's free-market theory is as confounded by recent developments in the United States as by those in Japan. Ironically, according to this new evidence, M&R's general claim 'that Japan is just like everywhere else' may have some truth – but for entirely different reasons.

5. Corporate governance and closely-held companies in Japan: the untold story

Tomoyo Matsui*

Most of the English literature on Japanese corporate governance focuses on large, publicly listed companies. For example, the current debate over the erosion or the endurance of the 'J-firm' – characterised by boards of internally promoted directors, main bank monitoring, *keiretsu* cross-shareholding arrangements, low-level M&A activity and lifelong employment (Aoki, 1988) – revolves around governance features typically observed in large-scale, publicly listed and internationally renowned corporations.

Yet listed companies account for only a fraction of all business enterprise in Japan. As of 30 November 2007, there were 4,000 companies listed on one of Japan's six stock exchanges.[1] By contrast, surveys by the Ministry of International Affairs and Communication (MIAC), 2004a; 2004b) show that there are over 5 million unincorporated businesses across the country, 2.86 million of which own offices or factories. A survey of taxation records by the National Tax Agency (NTA, 2005) reveals that there are 2.59 million incorporated entities. Of these, 1.45 million are private, closely-held (or 'limited liability') companies (*yugen kaisha*)[2] and a further 1.04 million are companies limited by shares (or 'joint stock' corporations, *kabushiki kaisha*). Although these statistics derive from surveys conducted at different times and with

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1 According to the public websites of the relevant exchanges, 2,409 companies are listed on the Tokyo Stock Exchange, 1,065 on the Osaka Stock Exchange, 976 on JASDAQ, 392 on the Nagoya Stock Exchange, 144 on the Fukuoka Stock Exchange and 88 on the Sapporo Stock Exchange. These figures include foreign and cross-listed corporations.

2 The Company Law has abolished the closely-held (limited liability) company (*yugen kaisha*). This is now subsumed as a type of company limited by shares (*kabushiki kaisha*). Closely-held companies incorporated prior to the Company Law must continue to use the term *yugen kaisha* in their corporate name to distinguish themselves from companies established under the Company Law (arts 2ff of the Company Law Implementation Law, No. 87 of 2005).

different methodologies,[3] it is clear that listed companies comprise less than 0.004 per cent of stock corporations, 0.002 per cent of all incorporated entities, and a negligible fraction of all business associations in Japan.

Smaller companies are also major players in Japan's labour markets (as outlined in Wolff's Chapter 3 in this volume). To be sure, the majority of companies (1.31 million out of 1.53 million companies: MIAC, 2004b) employ less than 20 regular employees and operate only one place of business. Thus, limited liability companies hire between zero and four regular employees (66.7 per cent of all companies) or between five and nine (52.4 per cent); and more than 50 per cent of stock companies have less than nine regular employees (MIAC, 2004b). Even so, at least 10,000 corporations employ more than 300 regular employees (MIAC, 2004b), a greater overall number than the 4,000 listed companies. Further, small-sized companies with less than 100 million yen paid-in capital, accounting for 98.4 per cent of all stock companies (NTA, 2005), retain 58 per cent of all regular employees (MIAC, 2004b).

Clearly, small and closely-held companies matter. Yet, despite their economic presence (Small and Medium Enterprise Agency or SMEA, 2006, 2007) both as the dominant form of incorporated entity (Kanda, 1998) and as the most significant employer of the Japanese workforce, the corporate governance of small, closely-held companies is virtually unexplored, especially in Western-language literature. This chapter therefore tells the tale. The story involves two subjects: the legislative regulation in pursuit of corporate forms and governance systems that best suit small enterprises; and judicial treatment of shareholder conflicts that typically beset smaller companies. The narrative is historical: it traces the incremental developments in the law and policy on the two subjects leading up to the enactment of the Company Law (No. 86 of 2005, in effect from 2006) and analyses the impact these developments have had – and will have – on smaller companies.

A key theme to emerge from this narrative is that the legislature and the judiciary have applied various regulatory techniques to distinguish between larger and smaller firms, but the lines of distinction have been more blurred than bright. For example, Section 1 of this chapter observes how Japanese corporate law initially distinguished between larger and smaller firms on

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[3] The NTA (2005) and the MIAC (2004a, 2004b) use different methodologies to generate their statistics. The former is a survey based on filing returns, dispositions and tax payments for the financial year; the latter is based on a distributed questionnaire and, therefore, has a higher margin of error. One of the most pre-eminent scholars of Japanese corporate law, Egashira (2006) relies on data from the NTA for the number of small corporations and MIAC data for employment figures and numbers of non-incorporated entities. This chapter adopts the same strategy.

formal or *definitional* grounds, that is, by organisational form, capital size or type of shareholdings. Using the contrast with *policy-push* law reform developed by Shishido (2001, 2007), this represented a *demand-driven* project. As explained further below, rather than trying to use the law to promote certain policies and systematic change, the project aimed to meet the existing needs of closely-held, family-dominated companies. Primarily, this was achieved by offering them a more relaxed set of capital and governance requirements. For example, prior to the enactment of the Company Law, corporate law enabled smaller enterprises to incorporate as private, limited liability companies (*yugen kaisha*) and leave larger firms to assume the form of a stock corporation (*kabushiki kaisha*). However, these formal distinctions were not always successful. For example, the law did not prevent smaller companies from incorporating as stock corporations or larger companies from embracing the limited liability format. With the passage of the Company Law, the formal distinctions between small and large companies have blurred even further. Thus, the Law abolished the limited liability class of company (although limited liability companies incorporated prior to the Law were allowed to continue to operate in their current form: Company Law Implementation Law (No. 87 of 2005)). Further, large and small companies may have overlapping governance mechanisms (although minimum governance requirements do vary by the size and type of the company: arts 327 and 328).

Section 2 of this chapter then explores how the Company Law now embraces an alternative approach to distinguishing between small and large companies. The Company Law distinguishes on the basis of *governance structure* – creating a menu of corporate governance options depending on firm size and shareholdings. This approach reflects more of a *policy-push* effort – an attempt by the government to encourage as many small enterprises as possible to adopt a business model that will enable successful entry into new and innovative industries. Although it too adopted aspects of a deregulatory approach, it was not so much a *demand-pull* project – that is, a response by lawmakers to industry demands for regulatory change. With many existing small companies with low productivity unlikely to survive in light of fundamental changes to industrial structure (Egashira, 2006, p. 6), the policy rationale of the flexible menu of governance structures is to promote business models suitable for new, nimble and innovative small business operators.

Section 3 of this chapter then turns to the judicial approach to governance of smaller firms. Unlike the twists and turns in the legislative regulation of the organisational and governance structure of closely-held companies, the judicial doctrine on resolving shareholder conflicts has remained largely unchanged. Even so, the Company Law looks likely to open up new types of

shareholder conflicts that will demand judicial attention. This is because the Law has abolished most of the former mandatory rules under the Commercial Code (*Shoho*), which exacerbated problems endemic in formal court processes in addressing problems of shareholder oppression (Shishido, 1990). Instead, the new Company Law sanctions a wider range of management structures and share schemes. However, problems may remain or resurface in new guises. In particular, the relaxed class-share provisions in the new Law potentially arm shareholders in smaller companies with a greater array of tactics to oppress the minority. Further, the courts might take cues from recent directions in takeover jurisprudence for public companies (outlined in this volume's Chapter 8 by Kamiya and Ito) to develop the oppression doctrine for closely-held companies in new ways.

1. FORMAL CORPORATE GOVERNANCE AND THE PUBLIC/PRIVATE DIVIDE

The corporate governance story of smaller companies in Japan is a counter-narrative to the broader story of corporate governance of large, public and typically listed companies. Over the course of post-war corporate legal history, successive reforms have aimed to tighten the accountability of large, mostly public companies. These have had flow-on effects for small- and medium-sized firms. Acknowledging that smaller enterprises have different needs, however, corporate law has sought to provide different standards for larger and smaller incorporate entities.

One technique to do so was to distinguish companies on the basis of capitalisation. For example, the 1974 Special Law on the Corporate Governance of Stock Corporations (No. 22 of 1974) introduced three stock company categories: large (more than 500 million yen of paid-in capital), medium and small (less than 100 million yen of paid-in capital). Under the statute, large companies were required to keep both accounting and general auditors; small corporations required only general auditors and were exempted from inspections on operational matters. The public outcry in the wake of the Lockheed bribery scandal in 1975, and the corresponding loss of public confidence in the corporate governance of major corporations, led to further reforms in 1981. These mandated a full-time auditor and multiple auditors for large companies. Subsequent reforms in 1990 took a different approach, this time recognising the need for different types of governance for public and closed corporations. On the assumption that public corporations were a sub-set of large companies, the 1990 reforms introduced governance distinctions based on capitalisation (Inaba, 1983, p. 2). These reforms reflected a concern for stakeholder protection. That is, since large corporations

commanded significant financial resources and carried out a large volume of transactions, more stringent governance requirements were set for large companies.[4]

Another technique was to set governance standards based on shareholding arrangements. For example, the 1994 reforms provided that companies with restrictions on share transfers – typical in smaller, stock corporations – were entitled to buy back shares and required a super-majority vote to allocate third-party options.

The third technique was to provide different organisational forms depending on whether shares were closely-held or dispersed. Larger companies were expected to incorporate as stock corporations under the Commercial Code; closely-held companies were expected to incorporate as *yugen kaisha* under the provisions of the Limited Liability Company Law (No. 74 of 1938). Entities formed under the latter were prohibited from approaching the public for capital and were limited to 50 members (art. 8(1)). Share transfers were subject to various restrictions to protect against minority oppression. Under the Law, members were guaranteed a role in management and reporting requirements were minimal. This attempt to create different regulatory regimes for smaller and larger entities, however, was not entirely successful. Small, family-owned companies still incorporated as stock corporations, and larger firms with dispersed shareholdings registered as *yugen kaisha*.

A number of reasons account for this failure. First, the caps on shareholder numbers were too generous. The limit of 50 shareholders for *yugen kaisha* was large enough for many larger firms to enjoy the more relaxed regulatory requirements of the Limited Liability Company Law. Conversely, the Commercial Code requirement that stock corporations must have a minimum of seven shareholders was low enough to allow many family businesses to incorporate as such.

Second, many smaller enterprises chose the stock corporate vehicle because it was regarded as the more prestigious form of business organisation. This was recognised in the lead-up to the 1986 legislative amendments when reformers expressed concern that, as a result, many small-scale stock corporations lacked a healthy capital base (Inaba, 1983, p. 3). The 1986 reform enabled incorporation with a single original shareholder, but, to compensate for this simplified incorporation and reinforce the creditworthiness of start-up stock companies, the amendment required 10 million yen of paid-in capital for stock companies at the time of incorporation.[5] Yet even this reform did not

[4] Some scholars (for example, Takeuchi et al., 1985, p. 6) argued that the distinction policy and its prospects for success were still not clear a year before the legislation was enacted.

[5] Prior to this, the law required that joint stock corporations have seven

achieve its hoped-for result: firms were still interested in the reputation of their businesses and, as such, many stuck to the stock corporation 'brand'. However, with the collapse of the bubble economy in Japan – and the across-the-board write-downs in land and building values – many smaller enterprises were forced to incorporate as *yugen kaisha*. This was because founders who could not gather 10 million yen in cash at the time of incorporation,[6] and business owners who kept less healthy books, began to select the limited company form for its much more relaxed governance structure. According to the MIAC (1999), the number of stock corporations decreased by 16,000 (or 2.0 per cent) while limited corporations increased by 11,000 in 1996.

Third, although the 1986 reforms sought to make stock corporations larger and more robust and to segregate smaller enterprises into limited liability (or small) company forms (Inaba, 1983, p. 5), the Limited Liability Company Law was not well designed to attract small business operators. With its complex mass of cross-references to the Commercial Code, the Law not only was difficult to understand but also prevented the development of distinctive case law for smaller firms. Paradoxically, this prevented less legally sophisticated new businesses from choosing the limited company form. Nor did the 1990 amendments prevent larger enterprises with abundant capital choosing the limited company form with lower expectations about generating shareholder returns, and achieving a more relaxed governance structure.

By the turn of the 21st century, the jurisprudence on corporate governance had blurred the line between smaller and larger firms even further. In the 1990s, attention turned to the governance of public corporations and the need for a more shareholder-oriented system of governance. Several scandals in 1991 regarding unlawful compensation payments by security firms to large, wealthy clients led to reforms in 1993 aimed at strengthening the monitoring of the board. New amendments introduced the shareholder derivative suit, bolstered shareholder rights to inspect the books, and boosted the independence and stability of auditors.[7] After reformers questioned the effectiveness

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founders contribute capital payments of over 50,000 yen and limited companies have their founders pay in more than 100,000 yen. The policy rationale was that multiple founders would ensure an appropriate level of capital for the conduct of responsible business, although this was not often realised in practice. The legislature abandoned this approach and focused on paid-in capital to prevent fraudulent incorporation.

[6] Naturally, some firms chose not to convert to limited corporation form but managed to increase their nominal capital. This caused changes in the nature of stock corporations after 1998 (Hyuga, 2002, p. 28).

[7] For example, the 1993 amendments increased the term of auditors from two to three years, lifted the number of required auditors at large-size corporations, introduced the outside auditor, and created the board of auditors system. See also the Appendix in this volume's introductory chapter.

of the auditor system for shareholder returns (Egashira, 2004, p. 4), the 2002 reforms to the Commercial Code introduced an optional committee system involving more outside directors (outlined in Lawley's Chapter 6 in this volume). With these reforms, the stock company form became more fragmented, offering more varied forms of governance and focusing more on shareholding than overall firm size. If the previously distinct *yugen kaisha* were to be integrated into this new regulatory design, this would warrant a significant rewrite of the Limited Liability Company Law. But the 2005 reforms abolished the limited liability company category altogether, leaving in place the previous law applicable only to limited liability companies incorporated before 2006.[8] Thus, all newly incorporated firms were to be stock corporations under the provisions of the new, consolidated Company Law.

2. POLICY-DRIVEN CORPORATE GOVERNANCE AND THE OLD/NEW DIVIDE

The new Company Law is widely thought to target mostly Japan's larger companies (Aizawa and Kanda, 2006, p. 18). But this is not necessarily so. The statute offers a variety of governance structures suitable for smaller companies. The SMEA, the key regulator for smaller firms, has noted the importance of the Company Law for implementing the broader economic policy goal of grooming smaller businesses for new, innovative ventures. The Law, in the view of the SMEA, provides the means for management succession or restructuring in pre-existing smaller corporations. Although there is no recent evidence to suggest that the Law is being used in this way, this does not rule it out as a future possibility. And clearly smaller firms do need a corporate shake-up. The recession of the 1990s greatly changed the industrial context for doing business, and smaller firms in particular were struggling – many even failing – in these depressed and altered economic conditions.

2.1 Changes to Industrial Structure

For most of the post-war period, closely-held companies were more interested

[8] The pre-existing limited liability companies remain as 'exceptional limited liability companies (*tokurei yugen kaisha*)', and are governed under arts 2–46 of the Company Law Implementation Law. The Law abolished the cap of 50 shareholders as well as the requirement to disclose shareholders' names and contribution amounts (art. 5(1)). On the other hand, companies are now required to keep new accounting books on shareholdings (*kabunushi shihonto hendo keisansho*; arts 2, 27) and to make public notices available to the media (arts 2, 5(2), 5(4), 28).

in employee welfare (Shishido, 2000, p. 201) than shareholder primacy. Indeed, as late as 2003, 40 per cent of companies failed to provide notices of meeting or even hold shareholder meetings at all (Ieda and Hirose, 2003, p. 28). Further, more than 40 per cent of those with paid-in capital of between 10 million and 20 million yen retained non-active, 'honorary' directors because of their ties to a particular community. This was possible because closely-held companies did not need formal governance structures or devices to keep them accountable to outside stakeholders. A stable industrial structure and regular economic growth ensured few conflicts between firms and stakeholders. *Keiretsu*-style, relational transactions with suppliers and others, and relationships with main banks (explained in Puchniak's Chapter 4 in this volume), underpinned industrial stability. Larger firms acted as both suppliers and customers for smaller firms, sometimes even as parent corporations. The involvement of these larger corporations, as well as main banks and tax accountants (Ieda and Hirose, 2003, p. 31), disciplined management. Although smaller firms were susceptible to exploitation by their larger corporate counterparts, they nevertheless benefited from their research and development as well as access to their manufacturing lines, marketing networks and financial resources (SMEA, 2007).

All this changed in the 1990s, as Kamiya and Ito (in Chapter 8) emphasise also in regard to Japan's larger public companies. The post-bubble recession saw the number of businesses tumble. According to the SMEA (2007), non-agricultural businesses decreased from 6.62 million in 1989 to 5.71 million by 2004; incorporated and unincorporated entities fell from 5.35 million in 1986 to 4.34 million in 2004. From 1985, smaller companies were declining by 12,000 firms annually. Between 2001 and 2004, 168,000 businesses were established while 290,000 closed (SMEA, 2006). Overall, the number of corporations (including stock corporations, limited liability companies, and other entities) declined by 8.3 per cent in five years, from 1.67 million in 1999 to 1.53 million in 2004 (MIAC, 2004b). Smaller enterprises – especially personal businesses – have recorded the more dramatic losses. Whereas the number of corporations fell by 3 per cent to 2.84 million between 1999 and 2004, the number of personal businesses plummeted 11.8 per cent to 2.86 million. Likewise, corporate employment dropped 2.1 per cent in the same period, whereas employment in personal businesses shrank 8.3 per cent.

Two factors account for these alarming losses. The first is Japan's ageing population. For example, 43 per cent of those firms that ceased business in 2002 had self-employed individuals aged over 60 (SMEA, 2006). The greying workforce gave rise to the problem of corporate succession. The Ministry of Economy, Trade and Industry (METI) calculated that 25 per cent (or 70,000) of corporate closures during the recession were due to difficulty in finding corporate successors, resulting in job losses of 250,000 to 300,000 each year (SMEA, 2006).

The second factor is the far-reaching changes to the Japanese market. The collapse of the bubble economy especially wreaked havoc on the labour market for small businesses. During the 1990s, smaller firms froze wage increases and stopped recruiting younger, regular employees.[9] Labour was sourced from temporary staffing agencies, as was the case with larger firms. Yet even during the recovery phase of the Japanese economy, small businesses continued to fail to attract staff (SMEA, 2007). Recent surveys show that the severest shortage exists in the recruitment of core employees who can design or implement projects. This indirectly explains the trend of many small companies winding up. During the 1990s, banks also became more selective in choosing borrowers. Corporate borrowers with fewer regular employees were more likely to be denied a bank loan or have their loan amount reduced (see, for example, SMEA, 2004, 2007). Further, prominent public companies shifted their transactions away from smaller, domestic firms to more cost-effective overseas enterprises. The term of transactions also became shorter. Although long-term transactional and financial ties have not entirely disintegrated, the relationships have apparently become more strategic.[10] The recession left many small corporations with little financial and negotiational power to exploit independent sales channels that developed in response to the changes taking place involving bigger corporations. Instead, smaller enterprises became even more dependent on larger firms and increasingly unable to assert an independent bargaining position, resulting in a slow recovery of profitability in the small and medium enterprise sector (SMEA, 2007).

Yet this economic malaise failed to spark interest among smaller firms to revisit corporate governance. According to a survey by Ieda and Hirose (2003, p. 30), small companies were largely uninterested in class shares that might facilitate succession. Small business managers were apparently more interested in share buy-backs, something that was made possible by 2001 reforms and was quickly exploited by many soon after enactment.

2.2 New SME Industrial Policy

Post-bubble economic slowdown and changes to the Japanese market struck smaller enterprises the hardest. Some enterprises – mostly medium-sized – remained viable by diversifying their marketing networks and their debt

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[9] The SMEA (2006, p. 20) reports that older people tend to work at smaller companies. This suggests that smaller companies still aim to protect the jobs of current employees at the expense of profit margins.

[10] Small companies are also moving their businesses overseas (SMEA, 2007, p. 9). This is due to shortened transaction terms, diversification of transacting parties and increasing information flows.

financing with banks; but weaker firms were struggling to adapt and were being left behind.

In response, METI formulated a small and medium enterprise (SME) revitalisation policy. It argued that active entry and quick exit would kick-start the sector (SMEA, 2006, p. 5). New entry was especially important. METI proposed that firms in mature business fields should take advantage of unique local resources or know-how. Corporate newcomers entering new growth industries were to be encouraged to be innovative, technology-driven, responsive to new information, diverse with their business dealings, and nimble enough to stay abreast of the latest trends through continuous investment in new measures (SMEA, 2007). After conducting several surveys and publishing reports, the SMEA argued that there was a demand for corporate law that offered incentives for small enterprises (SMEA, 2003, p. 3).

To give voice to this policy position and thereby arrest the decline in SMEs, a series of special laws were passed. These include the Promotion of New Industries Law (No. 152 of 1998); the Special Measures to Promote New Businesses by Small and Medium Companies Law (No. 47 of 1995); and the Limited Liability Partnerships Law (No. 40 of 2005). The swift passage of these special laws reflected METI's strong position on promoting corporate entry. However, the corporate community did not respond well to these laws. A 2006 survey of company founders revealed that the majority thought the laws were too loose and encouraged irresponsible incorporation without an adequate capital basis for doing business (SMEA, 2007). Arguably, then, the METI position was more an idealistic blueprint for reform than a realistic plan for revitalising the SME sector. Certainly, the structural needs identified by METI were more potential than actual.

Other courses of action have been raised (by, for example, the Japanese Conference of Business Succession, 2005–06). The LDP, for instance, has mooted a special tax benefit for shares in estates, reducing entry by up to 80 per cent (Liberal Democratic Party, 2007, p. 6). The party argues that, with significant amounts invested in shares in estates, corporate successors might choose to close down entities rather than pay inheritance taxes. Although it is unclear what the impact of this reform might be, it has the strong endorsement of many corporations (for example, Zenkoku Hojinkai, 2007).

How might we characterise these reform initiatives? Returning to the useful distinction between demand-pull and policy-push reform (Shishido, 2001, p. 656), by stepping ahead of the anticipated needs of Japanese industry in order to promote change, METI's legislative package was clearly policy push. The special laws have operated primarily for those motivated enough to choose special types of corporations and to go through the process of filing with METI.

A possible turning point might have been expected when it came time to

weave entry-stimulation policy into general company law. The codification of the Company Law necessarily involves repealing special laws and integrating their provisions with the new statutory framework. But the Law also covers pre-existing corporations with formulaic charter provisions and with no detailed *ex ante* bargaining on corporate control. Further, the traditional view has always been that corporate law should be a basic law about organisations, not an expression of industrial policy (for example, Tatsuta, 2007, p. iii); in other words, corporate law *should* be demand pull, not policy push.

Yet the policy-driven momentum continued. The 2003 METI study group report, 'The Expected Form of the New Company Law from the Perspective of Small and Medium Enterprises' (SMEA, 2003), for example, focused on remedying the law's previous neglect of smaller companies and its inconvenient rules for new, start-up ventures. In addition, the special laws appear to have had an encouraging degree of impact. The Promotion of New Industries Law was especially popular, with incorporations under this statutory scheme numbering more than 30 000 at the beginning of 2006 (Sadamori, 2006, p. 58). Other areas of company law, such as mergers and acquisitions (M&A, contextualised in Pokarier's Chapter 9 in this volume), also underwent METI-led reforms before 2005.

Academics also argued that radical change was necessary, especially greater flexibility in the ability of companies to customise their corporate charters (Uemura, 2000, p. 16). The trigger for this was the growing activism of shareholders in public companies, and the emergence of issues such as class shares and shareholder rights in takeover conflicts. Previously, academics argued that neither *ex ante* nor *ex post* relief was sufficiently flexible to accommodate the needs of minority shareholders. They proposed doctrines such as 'abuse of majority vote' (for example, Tatsuta, 1962) and an expanded fiduciary duty of majority shareholders towards the minority (for example, Saegusa, 1970). But these standards could not be tailored to meet the needs of individual companies. The 2000s generated new waves of thinking, this time in favour of individually tailored governance, not only for private, closely-held companies, as some had previously proposed (Inaba, 1983), but also for strategically-minded public companies. Under this view, pre-negotiated, detailed provisions in corporate charters were better able to provide relief for non-controlling shareholders.

This approach was a significant departure from previous regulatory practice. Unlike the approach (described in Section 1) of differentiating between public and private companies and segregating corporate law accordingly, the holistic Company Law adopted a unified approach. Shareholder conflicts in different companies were treated as a single, all-encompassing regulatory category (Kondo et al., 2004a, 2004b). The resulting regime was also an enabling one, permitting choice in share schemes and governance structures.

2.3 Overview of the Company Law

The new Company Law therefore reflects two trends. The first trend – policy push – is the promotion of corporate newcomers to the SME sector. To be sure, the legislative committee did not directly discuss and analyse industrial changes in Japan; but it did accept METI's entry-promoting policy. Like the special laws that preceded it, the Company Law encourages market entry by new SME enterprises. This is achieved by abolishing paid-in (nominal) capital requirement for incorporation, and by allowing sophisticated investors to bargain freely over the terms of the corporate charter. For the first time, company law jurisprudence considers corporate governance in strategic terms (Shishido, 2006, p. 7; Nomura, 2006, p. 9; Kansaku, 2006, p. 36). Thus, the Law enables extensive negotiation over the company's share and governance schemes. For example, it allows the company to define share classes that deprive minority shareholders of the right to distribution (art. 108(1)(1)), the right to vote or make proposals (art. 108(1)(3)), and the right to nominate directors (art. 108(1)(9)).

By contrast, the second trend – an example of demand pull – is continuing deregulation for pre-existing smaller companies. Deregulation includes codification of judicial standards, such as allowance for de facto shareholder meetings. But it also includes new drafting innovations, such as the statutory menu of governance systems available to all companies. Freedom to choose, of course, is far from absolute. The options are more tightly proscribed for public companies. So, too, for large, non-public companies, where the choice is: (a) a board of directors, accountants and governance committees, (b) a board of directors, accountants and a board of auditors, or (c) a board of directors, accountants and one or more auditors. Importantly for this chapter, however, small and closely-held companies have the greatest flexibility to pick-and-choose among the options. Thus, a company that restricts transfers for all of its shares is not required to have a board of directors (art. 372(2)) or a board of auditors. It may even limit the auditors' authority to simply inspect the accounting records (arts 389, 328). If a smaller company retains a professional with accounting knowledge and experience to act as an accounting consultant (*kaikei-sanyo*), it need not even retain auditors at all (art. 372(2)). In addition, smaller companies are allowed to extend the term of the directors from the basic tenure of two years to up to ten years (art. 332). Equally important for practice, closely-held companies enjoy relaxed management formalities. One-person companies, for example, may choose single directors or allow documented resolutions in place of board meetings (art. 370), thereby dispensing with formal monitoring and entrenching management control.

Nonetheless, these two trends overlap. Innovations to serve new market entrants have equally served more traditional business, thereby distorting the

policy underpinnings of the Company Law. For instance, new governance structures may be adopted by firms to ensure good practice – or, more cynically, to strengthen managerial powers. Greater flexibility to incorporate may attract innovative, new enterprise – as well as ordinary small businesses. The SMEA has even gone so far as to indicate that the chief target of the legislation is existing SMEs – not new ventures – when publicising and encouraging use of the new law.[11] Despite this, its follow-up research revealed that most pre-existing corporations were not interested in complicated class share schemes and did not understand the details of the new law (SMEA, 2007, p. 3).

Yet the provisions to provoke new market entry might actually force changes in the corporate governance of closely-held companies. To be sure, the empirical evidence points to early reticence. For example, former limited liability companies with long-running businesses,[12] and small stock corporations with authoritarian management,[13] seem to be uninterested in voluntarily tightening governance or introducing sophisticated class share schemes. Thus, 52 per cent of companies expressed no interest in issuing class shares, with the most common class share issued to date being the share with the buy-back option (31 per cent: SMEA, 2007, p. 18). Further, some commentators expect accounting consultants to be unpopular without incentives to make use of them (Kanda, 2006, p. 6). Indeed, the SMEA reports that 60 per cent of its sample showed no interest in introducing either professional accountants or accounting consultants (SMEA, 2007, pp. 15–16). Even so, there is good reason to expect changes in the governance of closely-held entities. First, the tightening of professional accounting standards[14] – which banks and other

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[11] For example, the SMEA has distributed a brochure entitled *Yoku Wakaru Chusho Kigyo no Tame no 33 mon 33 to* [Easy-to-Understand 33 Q&As on the New Company Law for Medium and Small Enterprises], <http://www.chuushou.meti.go.jp/zaimu/kaisya/kaisyahou33/kaisyahou.htm>. This brochure extensively focuses on the fact that the new law allows non-board corporations, the power to perpetuate family control of shares, and longer terms of appointment for owner-directors. The merits of the new corporate venture form are only briefly discussed with respect to the omission of the nominal capital requirement.

[12] The SMEA expects that limited liability companies with 15 to 30 years' operation are most likely to convert into stock corporations (SMEA, 2007, p. 6).

[13] The SMEA reports that the most utilised items introduced by the Company Law include the extension of the term of directors and document-based board meetings, the introduction of which was viewed positively by 30 per cent of the sample (SMEA, 2007, p. 7). Other changes in governance structures have not proven to be as popular.

[14] See *Chusho Kigyo no Kaikei ni Kansuru Shishin* [Principles on Accounting of Medium and Small Enterprise], last amended on 27 April 2007, by the Japan Federation of Certified Public Tax Accountants' Associations, the Japanese Institute of Certified Public Accountants, the Japan Chambers of Commerce and Industry, and the Financial Accounting Standards Foundation, <http://www.nichizeiren.or.jp/taxpayer/chusyo.html>.

financial institutions utilise for assessing loan applications – might necessitate the involvement of accountants in smaller firms, especially those that need outside capital. Second, increased enhanced powers for shareholders – in theory or on the books, even if not necessarily in practice – may force even the most indifferent directors to rethink governance to protect managerial power. For example, shareholders can make proposals before or at shareholder meetings, even acting alone (art. 303(1)). In companies without auditors or an auditor board authorised to monitor corporate operations, shareholders are allowed to call board meetings, directly or by request to the corporation, to prevent unlawful conduct by directors (art. 367). Shareholders, too, are basically allowed to bring derivative suits (art. 847).[15] In companies where all shares are subject to transfer restrictions, shareholders may challenge share issuances up to one year after issuance (art. 828(1)(2)). Also, current limited liability corporations may choose to convert to a partnership company (*mochibun kaisha*),[16] instead of a stock corporation, to relieve themselves of the requirement to disclose their annual balance sheets.[17]

3. SHAREHOLDER REMEDIES

3.1 Prior to the Company Law

The legislative history of corporate governance has been an ongoing – and not entirely successful – series of efforts to carve out a regulatory space unique to smaller entities. These have been based initially on formal incorporation requirements and, more recently, on policy-driven initiatives to promote flexible governance systems and share schemes. This history includes efforts to meet the needs of both shareholders and creditor-stakeholders.

By contrast, the judicial history relating to smaller firms has targeted shareholder conflicts to the exclusion of creditor protection. This should not be a surprise. After all, creditors protect themselves outside corporate law,[18] such as through bankruptcy proceedings, anti-trust suits or commercial

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[15] The requirement that a plaintiff must have been a shareholder for at least six months does not apply in the case of closed corporations.

[16] Unlike stock companies, partnership companies do not have shares that determine economic entitlements and participation rights. Such companies have greater freedom to determine the respective rights and duties of shareholders and directors.

[17] See Kansaku (2006, p. 47) for the governance advantages and disadvantages of the exemption to disclose annual balance sheets.

[18] Most small corporations rely on individual credit-checking investigations (not on management checks or nominal capital) when deciding to enter into transactions with counterparties (SMEA, 2003, p. 10).

litigation.[19] By targeting shareholder conflicts, the judiciary was better able to attend to the reality of closely-held corporations, since the vast majority of Japanese companies are held by only six or seven shareholders (Motoki et al., 1978, p. 13). The ensuing case law, however, is not without its problems. Even judges acknowledge that it is hard to discern the relevant rules because the cases are complicated and specific to the family conflicts raised by the facts (for example, Nagai, 2005, p. 27). Nonetheless, academic theories (for example, Hamada, 1974a, 1974b, 1974c) – still a de facto source of law in the Japanese legal system – have helped to clarify the trends in the mass of case law and explain the unique problems in smaller firms.

The nature and significance of shareholder disputes vary depending on the time period and the size of the firm. Take minority oppression, for example. Typically, the majority can squeeze out the minority by allocating shares that weaken the minority's investment stake, voting power or other participatory rights. This was not a problem in the immediate post-war period because the Commercial Code assumed that new shares would be allocated to existing shareholders in proportion to their holdings (Shishido, 2000, p. 196). However, the 1966 reforms to the Code authorised the board to allocate new shares to third parties provided the price was not preferential. Oppression soon became an issue, especially for closely-held companies because of the difficulty of determining a 'fair price' (Hamada, 1989, p. 21). The size of the company influenced the nature of the third-party share allocation, the corporate control issues these allocations provoked, and their respective resolution:

1. In larger firms, including listed subsidiaries and OTC companies, oppression took the form of interference in management by the parent or greenmailing by corporate gangsters (*sokaiya*: Milhaupt and West, 2000), causing minority shareholders to suffer unexpected losses in share prices.
2. In non-listed, medium-sized corporations, share allocations (usually less than 10 per cent) were invariably made to loyal employees who were required to return the shares upon retirement.[20] So long as the companies observed the law and gave shareholders the opportunity to object to unfair

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[19] SMEs most commonly encounter difficulties with accounts receivable, continuous transactions and consumer complaints (Takahashi and Murakami, 2007, p. 585).

[20] Share allocations of this type are honorary in nature and are called 'merit shares' (*koro kabu*). They are distinguishable from employee share ownership plans in public companies. Tabuchi (1969) first proposed merit shares and they have been popular ever since. The new Company Law has recognised and reinforced this practice by introducing a new right of management successors to claim shares with transfer restrictions (art. 140(1)).

share allocations to third parties, shareholder conflicts centred on the economic value of the shares, not any substantive or procedural irregularity with the share allocation. Most of these disputes were settled by guaranteeing appraisal rights and setting formulae for calculating reasonable share value.

3. In small, family-dominated companies, minority oppression involved questions of both corporate control and the economic value of shares (Shishido, 1984). Minority shareholders challenged share allocations by questioning the responsibility of directors to shareholders and stakeholders as well as the validity of the shareholder meeting that authorised the share issue (Shishido, 1988, p. 26). Most, however, wanted the share allocation set aside on the grounds that it was 'unfair' both in terms of the reason for the allocation and the price at which it was offered (Sakamaki, 1972). With courts reluctant to invalidate already-issued shares, however, many minority shareholders found they were unable to get injunctive relief because they were uninformed about their rights and acted too slowly (Hamada, 1989, p. 22). Despite the view that minority shareholders were well-equipped with legal rights (Shishido, 2000, p. 198), court action was rarely promising.

Minority oppression in smaller companies attracted scholarly attention. Corporate law scholars argued that formal governance structures would offer little help to closely-held, family-dominated companies. They proposed a relaxed governance structure (Shishido, 1988, p. 24), simpler invalidation of issued shares (Suzuki, 1984), and catch-all relief for minority shareholders such as an unrestricted right of appraisal (Hamada, 1983). These ideas were followed up by legislative action in the 1986 reforms, including a requirement that companies with share transfer restrictions hold extraordinary general meetings before allocating share options to third parties. This was expected to lead to more positive judicial outcomes in cases of unlawful issuance of shares (Egashira, 2005, p. 624).

Japanese courts have also sought flexible resolution of shareholder conflicts in closely-held companies. Although they have permitted de facto shareholder meetings, they have also set aside executed issuances when there was no notice for the meeting.[21] In intricate cases involving difficulties with proof, courts also encouraged voluntary settlement of the conflict, even where the amount at stake was small, rather than passing final judgment (Kanokogi

[21] The Supreme Court (16 December 1993, 1490 Hanrei Jiho, p. 134) gave injunctive relief to minority shareholders on the grounds that the unlawful failure to provide notice made it impossible for minority shareholders to take measures to protect their rights.

and Yamaguchi, 2007). This was expected to reduce the number of cases involving closed corporations, but ironically it still left a large number of complex and doctrinally tangled judgments.

Japanese courts also developed the oppression remedy in private, closely-held companies via *obiter dicta* in public company cases. The reason why public company cases are relevant to small, closely-held companies is that public companies typically issued only a single class of shares – preference shares and other classes of shares are new and relatively untested innovations in Japanese corporate law – and corporate control disputes are brought under the same article of the Commercial Code as those relating to unfair share issuances in private companies. These cases established a two-pronged test for invalidating share allocations (as explained in Kozuka, 2006, and this volume's Chapter 8 by Kamiya and Ito). The courts examined whether the shares were issued at a disproportionately unfair price ('substantive unfairness');[22] and whether the allocation was for the improper purpose of entrenching management control (the 'proper purpose rule').[23] However, since a market price is not available for shares in family companies, substantive unfairness has a different meaning in smaller companies. Other public company cases considered whether a director is liable in tort to shareholders for proportionate losses in share value. The courts generally denied relief, but did leave room for granting relief for closely-held companies (Kawashima, 2005). In these and other cases,[24] public company law helped define – albeit incidentally – the oppression remedy for smaller companies.

Prior to the enactment of the Company Law, therefore, corporate law scholars developed unique doctrines for *ex post* relief of shareholder conflicts, which in turn were slowly reflected in judicial precedents.

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[22] In one case, the Tokyo District Court (25 July 1989, 1317 Hanrei Jiho, p. 28) suggested the standard for invalidating a share allocation was an 'extremely preferential price'. However, a later judgment denied injunctive relief when the share price was discounted by as much as 40 per cent when the plaintiff could not establish that the primary purpose of the issuance was to entrench management control (Tokyo District Court, 5 September 1989, 1343 Hanrei Jiho, p. 28).

[23] The Tokyo District Court (25 July 1989, 1317 Hanrei Jiho, p. 28) allowed an injunction to invalidate a share issuance because of an extremely preferential price and an unjustified primary purpose of diluting the voting power of certain shareholders to maintain corporate control.

[24] Public company cases have also considered shareholder equality in cases such as those involving share divisions (Tokyo District Court, 29 July 2005, unreported) and share buy-backs (Osaka High Court, 14 March 2007, 1239 Hanrei Taimuzu, p. 294).

3.2 After the Company Law

How, though, might the Company Law affect the future course of shareholder oppression cases in small, closely-held companies? One possibility is that shareholders will be in a stronger position to bargain for their rights under recent *ex ante* governance and share planning schemes. With the legalisation of governance options and greater opportunities for shareholders to voice their concerns, shareholders might be expected to negotiate the terms of their participation in the company and exercise their rights to the extent permissible under their firm's particular governance structure, instead of turning *ex post* to the courts for intervention in shareholder conflicts. But there is no guarantee that shareholders at pre-existing, closely-held companies will become more active. Recent shareholder activism in public companies is not likely to be replicated in smaller, older firms, and shareholders are not expected to renegotiate their relationships within their firms. Thus, it appears that shareholders might still need to turn to existing or new minority oppression doctrine.

A second possibility is that stock exchanges might expand the scope for judicial scrutiny of oppression cases, especially in non-listed, smaller companies. Recently, Japanese corporate law has expanded the listing opportunities for smaller companies with fewer shareholders. However, the stock exchanges – such as the Tokyo Stock Exchange (TSE) – disallow certain share schemes that affect corporate control (such as 'golden shares'). The stock exchanges might reverse that, given the government's policy impetus to promote market entry for start-up venturers, as well as their own efforts to develop new listing markets such as Hercules in Osaka (previously: NASDAQ Japan) and Mothers within the TSE. If so, the exchanges will be forced to define desirable standards for such share schemes. This will lead to greater distinctions and evolution of the oppression doctrine depending on the existence of *ex ante* share planning, rather than capital size or number of dispersed shareholders.

The third possibility is that takeover jurisprudence for public companies might inform future developments in oppression doctrine for small, closely-held companies. As already noted, relief under the Commercial Code for public corporations was the same as that for family-owned entities: *ex ante* special majority approval and *ex post* suits for breach of director's duties or defective shareholder meetings. Recently, public corporations have begun to employ poison pills to prevent corporate takeovers, giving rise to questions over the conditions and prices of the issued options. In these lawsuits, courts had to rely heavily on the open-ended 'primary purpose' test, since the prices of options used as poison pills were difficult to calculate.[25] But the purpose of

[25] The leading judgment on this point is from the Tokyo High Court (20 March 2005, 1899 Hanrei Jiho, p. 56).

issuing such options is totally different from ordinary fund-raising. Eventually, administrative agencies and the courts had to carve out new standards to make the 'proper purpose' test more objective and specific to takeover situations (see, for example, the Guidelines proposed by METI and MoJ, 2005, outlined in Dooley's Chapter 7 and elaborated by Kamiya and Ito in Chapter 8). These developments, in turn, might help underpin more specialised and concrete tests for other types of share allocations, such as those oppressing the minority in smaller corporations.

A fourth possibility for the future evolution of the oppression remedy lies in how the courts interpret article 109 of the Company Law: the equal treatment of shareholders. At first sight, this possibility appears remote. Under the previous Commercial Code, for example, the equal treatment doctrine was relevant (although not explicitly mentioned) in oppression cases in both public and private companies.[26] However, since an unfair share allocation was usually accompanied by allegations of unlawful or oppressive conduct of the shareholder meeting[27] or undisclosed payments to particular family members or corporate gangs,[28] the equal treatment doctrine was not essential to the court's reasoning. Similarly, legislative commentary on the new article 109 insisted that the equal protection doctrine was only imported for former limited liability companies that had converted to stock companies (Aizawa and Iwasaki, 2005, p. 39); it was intended to reinforce that different treatment was possible under share class schemes and *not* to place a cap on the extent of this different treatment (Hadama, 2006, p. 107). Other provisions support this explanation.[29] As such, article 109 was not expected to be invoked in the takeover context (Economic and Social Research Institute, 2006). Scholars, too, accepted that the equal treatment doctrine could not play a role in invalidating share schemes. Concerned that companies may engage in abusive share planning (Nomura, 2006), some scholars instead argued that minority shareholders could challenge meetings approving arbitrary share schemes on the basis of 'abuse of the majority vote' (Komoto et al., 1990, p. 12).

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[26] See, for example, the judgments of the Nagoya High Court (19 January 2000, 1987 Kinyu Shoji Hanrei, p. 18: defects in shareholder meeting procedures in the selection of directors) and of the Kagoshima District Court (6 September 2000, unreported: directors' responsibility for sudden wind-ups).

[27] See the judgment of the Tokyo High Court (30 January 2003, 1824 Hanrei Jiho, p. 127).

[28] See the judgment of the Supreme Court (24 November 1970, 616 Hanrei Jiho, p. 97: nullification of a contract in which sums of money were paid to a shareholder who was a former manager).

[29] Article 109(2) permits closely-held companies to provide preferred treatment to individuals (although not shares).

For these reasons, the potential application of article 109 for the oppression remedy was largely neglected. So long as the share structure in their companies remained simple, minority shareholders in closely-held entities were unlikely to invoke the equal treatment doctrine. Instead, they would challenge share allocations on the basis of substantive unfairness or procedural defects. However, the equal treatment doctrine began to appear in shareholder disputes in public companies, especially where poison pills were employed. Initially, the doctrine was of indirect relevance in settling allegations of unlawful share allocations;[30] later, however, it assumed more central importance in takeover cases.[31] The first Supreme Court judgment on the equal treatment doctrine in the takeover context was delivered as recently as August 2007.[32] In the *Bulldog Sauce* litigation detailed in this volume's Chapter 8 by Kamiya and Ito, the plaintiff sought a vote at the target's shareholder meeting which authorised the issuance of options at a nominal price. The Supreme Court extended the scope of the equal treatment doctrine to cover options as well as shares. It held that, although the equal treatment gives way when the value of the enterprise is at stake, the extent of the inequality must not be exceptional.[33] The issuance of options in that case was decided not to be in violation of the equal treatment doctrine, irrespective of whether or not the plaintiff was a corporate raider. But the fact that shareholders began to utilise the equal treatment doctrine itself presents potential for its future application, even beyond situations involving actual or potential takeovers of public companies.

Although the equal treatment doctrine is not regularly invoked, other related doctrines that presume equality, such as abuse of majority vote and fiduciary duties towards minority shareholders, are likely to make their way into public company jurisprudence (Kondo et al., 2004a, p. 10). Eventually, this will probably influence the direction of case law in non-public cases. This is because, as more liberal share schemes are adopted in public and closely-held companies alike, conflicts within venture, family and public corporations are expected to become more comparable.

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[30] For example, see the judgment of the Tokyo District Court (15 June 2005, 1990 Hanrei Jiho, p. 156). The Court awarded an injunction to invalidate an allocation of options on the grounds that the irregular issuance procedure was likely to harm the expectations of pre-existing shareholders. Although not argued explicitly, the case was clearly concerned with the equality of shareholders.

[31] See the judgment of the Takamatsu High Court (23 August 2005, 251 Shiryoban Shoji Homu, p. 220).

[32] See the judgment of the Supreme Court (7 August 2007, 1809 Shoji Homu, p. 16: injunction invalidating a shareholder meeting). This case is also discussed in depth by Tanaka (2007a, 2007b).

[33] The extent of the permissible inequality is primarily judged by corporate executives, but courts may substitute their own judgment when the managerial decision-making process is unreasonable or where minority shareholders are oppressed.

4. CONCLUSIONS

This chapter has told the important story of corporate governance for smaller companies. How this story will further unfold depends on how smaller firms respond to the new regulatory design of the Company Law and how changed internal relationships, in both private and public companies, transform the nature of shareholder conflicts.

First, the new Company Law makes sophisticated governance and share schemes possible. Regardless of whether the new statute is moving ahead of shifts in Japanese industry (policy push) or answering the needs of closely-held firms (demand pull), the Law will inevitably shape the future of SME governance. This is true of new ventures as well as more established businesses. So long as the reforms embrace both deregulation and market-entry promotion policy, innovative new enterprises and old-style firms will be able to exploit the provisions relating to incorporation, conversion of organisational form, freely negotiated share schemes and flexible governance systems. As the SME sector becomes more innovative, market-oriented and diverse, governance systems will come under the spotlight. As third-party transactions become more strategic and outside monitors, such as main banks, retreat from involvement in firm governance, there will be a growing need for shareholder-oriented governance.

Second, the courts remain attuned to the reality of shareholder conflicts in closely-held entities. Many recent cases have scrutinised winding up and share buy-backs in the context of the unfair share allocation doctrine.[34] Even if the Company Law does not effect any changes to internal shareholder relations, the oppression remedy will remain important over the ensuing decade. New developments in takeover jurisprudence, especially following the semi-official encouragement of certain forms of poison pills (METI and MoJ, 2005) and more recently management buyouts (MBOs: METI, 2007), will continue to influence and expand the oppression doctrine for smaller companies.

[34] Some examples of recent cases include judgments of the Osaka District Court (5 March 2003, 1833 Hanrei Jiho, p. 146; on buy-back shares); the Tokyo High Court (29 March 2007, 1266 Kinyu Shoji Homu, p. 16; on unfair issuance of shares); and the Nagoya District Court (26 December 2001, unreported; on winding up).

6. Panacea or placebo? An empirical analysis of the effect of the Japanese committee system corporate governance law reform*

Peter Lawley

On two significant occasions in its modern history, Japan has undertaken law reform on a massive scale and at a blistering pace. In the 1850s, Japan embarked on the Meiji Restoration and achieved in thirty years a level of industrial development it had taken Western powers nearly a century to attain (Jansen, 1995). Beginning in the 1950s, post-war Japan transformed itself from a nation bombed into third-world status into the economic envy of the world only a few decades later (Dower, 1999).

Over the past fifteen years Japan has been attempting to repeat this feat. The collapse of the Japanese economy in the early 1990s and its stagnation during the 'lost decade' (Milhaupt, 2006; Nottage and Wolff, 2005) has spurred rapid and extensive corporate law reform. In the field of corporate governance, a number of these reforms fill the gaps left by the decline of traditional monitoring mechanisms (Gilson and Milhaupt, 2005, pp. 347–52; Puchniak, 2003, pp. 48–9). Some commentators argue that the nature of these replacement mechanisms signals a shift toward a US-style corporate governance environment (Kelemen and Sibbit, 2002; Hansmann and Kraakman, 2001, pp. 455–6; compare generally Nottage, Chapter 2 in this volume). A significant step in that direction was the enactment in 2002 of legislation giving large corporations the option of adopting a US-style committee corporate governance structure. The committee system requires a corporation to establish committees for audit, remuneration, and nomination within its board of directors.

In the months before and after the introduction of this legislation, international and domestic corporate law experts analysed the committee system and

* This is an updated and abridged version of Lawley (2007), that contains further references, especially regarding the interviews, and background newspaper articles, along with thanks to many individuals.

speculated about its likely impact on Japanese corporate governance (Gilson and Milhaupt, 2005; Puchniak, 2003; Egashira, 2004). Enough data are now available to make a preliminary assessment of the impact of the committee system law reform. This chapter examines the literature speculating on the committee system and assesses the potential of the new system to improve Japanese corporate governance. It isolates key issues of the committee system and evaluates the impact of the committee system relative to the reform as a whole. The conclusions of this assessment are then weighed against empirical research collected on the operational committee system.

This chapter refines the current understanding of the impact of the committee system on the Japanese corporate governance environment. This necessarily involves analysis and application of the theory underpinning corporate governance law and practice. The chapter identifies how the committee system impacts upon the work practices of professionals who are effectively charged with the responsibility to implement and evaluate the reform. The earlier theoretical analysis is then assessed against the empirical results to achieve a better understanding of the effect of the committee system in practice. The purpose of this chapter is to assist corporations and other parties make informed decisions about corporate governance issues in Japan. It also briefly explores possible areas for further reform to the committee system law and improvements to committee system implementation.

The results of the empirical research suggest that adopting the committee system itself does not have either a net positive or net negative effect on a corporation's performance. The cumulative effect of individual factors in a given corporation's case is more important. Nevertheless, the reform is having an impact at a macro level by forcing even non-adopting firms to reconsider their corporate governance structures.

Section 1 of this chapter explains the committee system reform in detail and places it in context with other recent corporate law reforms in Japan. Section 2 explores and analyses the theoretical framework of the committee system framed by earlier research. Section 3 details the conclusions of my telephone survey study regarding the committee system. These empirical data suggest that, in practice, the success of adopting a committee system depends upon the manner in which it is utilised by individual companies. Finally, Section 4 concludes that the operational committee system currently provides few advantages over the statutory auditor system. It also briefly addresses areas for possible reform of Japanese corporate law.

1. CONTEXT AND BACKGROUND

In late 19th century Japan, there was a growing perception among then modern

managers that the job of a corporate director was 'nothing but coming to the office daily, reading newspapers, and passing his time gossiping' (Egashira, 2004, p. 19, citing Yui, 1979). The view developed that directorial posts should be filled by executives, and as a result non-executive monitoring directors gradually disappeared from the Japanese corporate scene (Egashira, 2004, pp. 18–19).

The Commercial Code, enacted in 1899 (*Shoho*, Commercial Code, Law No. 48 of 1899),[1] and corporate governance practice over the following century reflected and perpetuated the philosophy that directors should also be executives. The original Commercial Code introduced the statutory auditor (*kansayaku*) system, a weak counterpart to the German 'supervisory board' (Baum, 1995, p. 169). Under that system, a statutory auditor is appointed by shareholders' resolution (now pursuant to the *Kaishaho*, Company Law, No. 86 of 2005, art. 329); but the auditor has no power to appoint or remove directors (arts 339–40). A statutory auditor's sole functions are to audit the company's financial statements and monitor the board of directors' compliance with the law (art. 381(1)). Recent amendments to Japan's corporate law have strengthened the monitoring ability of the statutory auditor by requiring large corporations (art. 2(6)) to have a board of at least three auditors – at least half of whom must be outside auditors[2] – and extending the term of office and the responsibilities of the auditors.[3] Japanese corporate law has never mandated outside directors for companies that use statutory auditors.

In lieu of a robust internal monitoring system mandated by statute, the Japanese corporate environment in practice developed unique monitoring mechanisms that effectively eliminated the need for non-executive directors (Gilson and Milhaupt, 2005, pp. 350–51). Large corporate groups, known as *keiretsu*, created extensive cross-shareholdings and reciprocal directorships (Gilson and Roe, 1993, pp. 882–4). This removed the market for corporate control and allowed managers to take a long-term view. The result was a culture of lifetime employment that granted all employees a strong interest in the company's future (Puchniak, 2003, pp. 46–7). Even today, the boards of many 'blue-chip' companies such as Toyota, Canon, and Mitsubishi consist of representatives from each of the company's business groups who have spent

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[1] Part 2 of the Commercial Code, which dealt with the law of corporations, was spun off into the new *Kaishaho*, Company Law (No. 86 of 2005). This passed the Diet in 2005 but did not come into effect until 2006.

[2] *Kabushiki Kaisha no Kansa-to ni Kansuru Shoho no Tokurei ni Kansuru Horitsu* (Law on Special Provisions of the Commercial Code Concerning Audits, Law No. 22 of 1974, amended by Law No. 44 of 2002) art. 18(1)). This provision has been superseded by the Company Law art. 335(3).

[3] *Shoho*, arts 273(1), 260–63(1). These provisions have been superseded by *Kaishaho* arts 336(1) and 383(1), respectively.

their entire careers climbing the corporate ladder (Ahmadjian, 2003). These internal monitoring systems were reinforced by a main bank acting as the principal lender and typically the largest shareholder of group companies (see further Puchniak, Chapter 4 in this volume). The resulting corporate governance framework has been described as the 'zenith of efficient managerial monitoring' (Puchniak, 2003, p. 46). Agency costs resulting from the separation of ownership and management were virtually eliminated. Throughout the 1970s and 1980s the success of this monitoring system was demonstrated year after year as corporate profits rocketed ever higher.

These internal monitoring mechanisms began to collapse, along with the Japanese economy, in 1991. Faced with the burden of extensive bad loans, main banks could no longer stand behind corporate managers. Management, in turn, began to sell off cross-shareholdings to free up much-needed cash. As the stability of Japan's corporate governance framework crumbled, even lifetime employment was no longer secure. In response, the Japanese government began the corporate law reform of the past decade to facilitate the corporate restructuring necessary in Japan's new economic reality (Gilson and Milhaupt, 2005, p. 351).

1.1 The Committee System

In May 2002, the National Diet of Japan passed legislation amending the Commercial Code to allow for the committee system corporate governance structure (*Shoho-to no Ichibu wo Kaiseisuru Horitsu*, Law Partially Amending the Commercial Code, No. 44 of 2002). However, in a fashion described as 'characteristically unusual' (Gilson and Milhaupt, 2005, p. 344), the Diet set up the committee system as an optional alternative to the existing statutory auditor system. The legislation was the result of a compromise between the Ministry of Justice (MoJ) and the business community. The MoJ initially proposed to replace the statutory auditor system with three mandatory committees under the board of directors and require all large corporations to have at least one outside director. The business community opposed this proposal on the grounds that: (a) no single board structure should be legislatively mandated, and (b) companies should not be forced to have outside directors (Gilson and Milhaupt, 2005, pp. 353–4).

Under the new law, if a company elects to adopt the committee system in lieu of the statutory auditor it must appoint three committees for audit, nomination, and remuneration (Company Law, art. 2(12)). Each committee must consist of at least three directors and a majority of the directors in each committee must be outside directors (art. 400). However, the same outside director may sit on all three committees. Companies that opt not to adopt the committee system retain the statutory auditor system and are not required to

have any outside directors. The committee system reform also strengthens the separation of monitoring and execution (art. 402) by requiring adopting companies to appoint executive officers, including at least one representative executive officer (that is, a chief executive officer or CEO).

1.2 Data on Committee System Adoption

Companies adopt the committee system by amending their certificates of incorporation. This amendment requires the approval of shareholders and is usually made at an annual shareholders' meeting. Seventy-one companies moved to the committee system in the first round of adoptions in 2003. As of October 2006, another 39 companies had adopted the committee system. The total adoption figure of 110 companies is partially misleading because it includes Nomura Holdings with its 13 privately held subsidiaries and Hitachi Ltd with its 21 affiliate companies. Aggregating these subsidiaries and affiliates, the total number of adoptions reduces to 76 companies (Japan Corporate Auditors Association, 2006).

Compared with the hundreds of thousands of companies in Japan, the number of companies that have adopted the optional committee system so far is low. However, it is significant for a number of reasons. First, the initial uptake was much larger than commentators had predicted.[4] Moreover, while not as high as when the legislation was first enacted, the adoption rate since 2003 has remained steady. Second, all of the adoptions have occurred in the wake of the Enron and WorldCom corporate governance scandals in the United States. Despite growing uncertainty about the effectiveness of the US-style committee system, a significant number of Japanese companies have adopted a monitoring system modelled upon it. Finally, a considerable number of the companies that adopted the committee system are large, high-profile firms. In addition to the Nomura and Hitachi groups, Sony, Orix, Toshiba, Konica Minolta, Mitsubishi Electric, Kanebo, the Resona, Tokyo Star and Shinsei banks, Fidelity Securities and the JASDAQ Securities Exchange have all moved to the committee system (Japan Corporate Auditors Association, 2006).

[4] Miwa Suzuki, 'Experts doubt many firms to follow Sony and adapt US-style structure', *Agence France-Presse (Japan)*, 29 January 2003.

2. THE GILSON AND MILHAUPT THEORETICAL FRAMEWORK

In light of the pessimistic predictions of commentators and the corporate governance scandals in the United States, it is logical to ask *why* many high-profile companies moved to the committee system. In quantitative empirical research conducted shortly after the first round of committee system adoptions, two Columbia University law professors examined a number of 'strategies of choice' as possible explanations for a company's decision to adopt the committee system (Gilson and Milhaupt, 2005). The authors acknowledged that it was too early at that time to assess the success or failure of these strategies. Nearly four years later, this chapter empirically tests the effect of committee system adoption with reference to the strategies of choice put forward by Gilson and Milhaupt.

In the same study, Gilson and Milhaupt measured the effects on share price of a company's first public announcement of intention to adopt the committee system. They concluded that 'average abnormal returns to announcements were negative but not statistically significant' (Gilson and Milhaupt, 2005, p. 366). While recognising the importance of share price effects, this chapter assesses the committee system law reform by examining whether, and how, adoption of the committee system improves a company's governance mechanisms. These internal factors are overlooked in an evaluation solely of share price.

In this chapter I use flexibility and monitoring as criteria for my assessment. The committee system is viewed as improving corporate governance if it enhances either flexibility, thereby increasing the options available to management, or monitoring (Milhaupt, 2006; Pinto, 1998). In this chapter I also assess the committee system in its capacity to achieve a higher market valuation for a company.

In Sections 2.1–2.3 below I isolate three key factors arising in Gilson and Milhaupt's strategies that potentially determine the effect of committee system adoption: outside directors, corporate groups, and industry. In Section 2.4, I additionally address the issues concerning executive officers – especially the CEO. I selected these four factors for analysis because they deviate considerably from the statutory auditor system, and are key aspects of a corporate governance structure that is supposed to be an improvement on the old system. I critically assess these four areas of inquiry and reach tentative conclusions as to the accuracy of the Gilson and Milhaupt study and how each issue contributes, or fails to contribute, to enhancing flexibility and monitoring. Section 3.2 then assesses these conclusions against the results of my qualitative empirical study detailed in Section 3.1.

2.1 Outside Directors

As explained earlier, a company with the committee system requires a majority of outside directors on each of its three committees (Company Law, art. 400). In contrast, a statutory auditor company is not required to have any outside directors but may optionally appoint them. In this sense, the committee system reform strengthens the monitoring role of the board of directors by increasing the number and the influence of outside directors. However, this goal is undermined by the relatively weak definition of outside director (Gilson and Milhaupt, 2005; Puchniak, 2003, p. 64; Egashira, 2004, p. 23). According to Japan's Company Law, an outside director is a director who is not presently and has never previously been an executive director, an officer, or an employee of the company or a subsidiary of the company (Company Law, art. 2(15)). The result of this definition, as Fujita (2004, p. 340) points out, is that the committee system can be used or abused in a number of different ways. It may be used to enable strict monitoring of management by truly independent outside directors. It may be used as a method for organising the hierarchical structure of corporate groups. Alternatively, a company may legally appoint family members, golf buddies, or old dormitory roommates as outside directors to ensure entrenchment of the incumbent management. The effect of committee system adoption could vary considerably depending on which of the above kinds of outside directors are appointed.

In considering the effect of committee system adoption, Gilson and Milhaupt (2005) draw a comparison between Japan and a South Korean corporate governance study demonstrating that the existence of outside directors tends to defeat a phenomenon known as 'shareholder tunnelling' in South Korea, that is, the control of a company by majority shareholders at the expense of minority shareholders (p. 360). Gilson and Milhaupt point out that, because Japan 'is not characterised by controlling shareholder capital structures, Japanese firms are not subject to widespread controlling shareholder tunnelling'. Instead, Gilson and Milhaupt posit that Japanese companies may suffer from what they call 'stakeholder tunnelling' – commitment by a company to maximising something other than shareholder value (p. 361). Especially in the period when *keiretsu* and main banks dominated Japan's corporate monitoring mechanism, creditor and employee interests were usually placed ahead of shareholders' interests (Gilson and Roe, 1993, pp. 879–82). Despite the similarities, Gilson and Milhaupt argue that the appointment of outside directors is unlikely to defeat stakeholder tunnelling in the same way that it has helped defeat shareholder tunnelling in South Korea. In other words, the committee system is unlikely to improve the monitoring mechanisms of statutory auditor companies. Gilson and Milhaupt give two

grounds for this view: (a) Japan has a loose definition of 'outside director', and (b) stakeholder tunnelling is a cultural characteristic of Japan (Gilson and Milhaupt, 2005, pp. 361–2).

Gilson and Milhaupt first argue that the loose definition of outside director in Japan does not ensure that outside directors are divorced from the interests of controlling shareholders and other stakeholders (pp. 361–2). However, the optional nature of the committee system works against this argument. Because the statutory auditor system does not require companies to appoint any outside directors, there appears to be little point in a company moving to the committee system if it intends to appoint non-independent outside directors. It may be, as Gilson and Milhaupt suggest, that there are reasons other than achieving stronger monitoring for adopting the committee system, such as a general signalling to the market. The strengthening of corporate groups is just one such possibility (pp. 364–5).

The appointment of outside directors who are not truly independent may not be as detrimental to the monitoring mechanisms of the committee system as Gilson and Milhaupt suggest. Puchniak (2003) argues that so-called 'grey' directors – outside directors who have a material relationship with the company or its management – are at least as effective as, or even more effective than, completely independent directors. Puchniak argues (2003, p. 65) that 'what grey directors lack in independent monitoring they make up for in the incentive to monitor'. However, a greater incentive to monitor is meaningless if the interests grey directors seek to protect through their monitoring are more likely to be aligned with management than shareholders. Puchniak further argues that a grey director's relationship with the company or key officers in the company gives them access to better information, which, in turn, increases their ability to monitor (Puchniak, 2003, pp. 68–9). However, as Egashira (2004) points out, this advantage may be largely nullified in Japan because many companies have directors who are neither executive officers nor outside directors according to the legal definition. These middle-ground directors commonly relay internal information to the outside directors (Egashira, 2004, p. 23).

Gilson and Milhaupt secondly argue that stakeholder tunnelling is a cultural characteristic of Japan and consequently there will be little monitoring improvement. A simple solution to this problem would be to fill more outside director positions with foreigners who do not share the cultural commitment to stakeholder tunnelling. However, there is little evidence that this is happening.[5] Gilson and Milhaupt recognise that the appointment of outside directors 'may turn out to be the hydraulics of change even if they are not its cause'

[5] Tim Burt, 'New Sony Chief Wants More Foreigners on Board', *Financial Times*, 13 March 2005.

(pp. 361–2). Certainly the fact that a number of Japanese companies have voluntarily appointed outside directors, and that several did so before the committee system reform was introduced, suggests a growing understanding of a need to protect interests other than those usually advanced by management (Komiyama and Masaoka, 2002). Sony, which has of its own accord appointed a majority of outside directors to its board, is an ideal example of this trend (Sony Global, 2006). Moreover, other recent corporate law reforms indicate a growing concern for the protection of shareholders' interests, especially those of minority shareholders (Milhaupt, 2006).

2.2 Corporate Groups

If a company intends to appoint only grey outside directors, which it can do under the statutory auditor system, another reason must exist for adopting the committee system. An alternative rationale for adopting the committee system put forward by Gilson and Milhaupt is to use it as a means of organising corporate groups, in other words, using grey outside directors to strengthen the bonds between group companies and enhance organisational flexibility (Gilson and Milhaupt, 2005, pp. 364–5). Indeed, as these scholars (p. 362) and others (Yanai, 2003) point out, the Hitachi and Nomura groups cited achieving stronger group cohesion as one reason for adopting the committee system. The extent to which a corporate group will benefit from adopting the committee system, however, is likely to vary according to whether it is a vertically-aligned corporate group with a parent company and subsidiaries or a more horizontally-aligned *keiretsu*.

A vertical group can achieve stronger group cohesion by adopting the committee system because the loose definition of outside director effectively gives the parent company the power to appoint the outside directors for its subsidiaries. Although the major shareholder of a statutory auditor company also has the power to appoint directors, the committee system allows a parent company to gain effective control of a subsidiary board's committees by appointing as few as two outside directors. The ability to control the nomination committee, in particular, gives the parent of a company with the committee system a considerable flexibility advantage compared with the parent of a statutory auditor company. Although the maximum amount of power a parent can obtain over a subsidiary is the same both for companies with the committee system and for statutory auditor companies, effective control is easier to achieve under the committee system. Of course, the outside directors appointed for this purpose are grey outside directors, so there is a risk that the goal of stronger group cohesion could instead result in stakeholder tunnelling. Indeed, it could be argued that appointing outside directors for the purpose of achieving stronger group cohesion *is* stakeholder tunnelling.

It would be more difficult for a *keiretsu* to achieve stronger group cohesion under the committee system if there were not a single controlling company, or small clique of controlling companies, that had significant control over the other companies in the *keiretsu*. Without a controlling company or companies, stronger cohesion could only be achieved within a *keiretsu* under the committee system if the member companies were able to coordinate effective appointment of outside directors among themselves. However, if such a *keiretsu* were to achieve stronger cohesion in this way, it would not be a result of the committee system but of the capacity for cooperation within the group.

Thus, it is the existence of a controlling company (or companies) that makes the objective of stronger group cohesion possible. The flexibility advantage the committee system offers to corporate groups can only be exploited if there is a controlling company with the power to appoint outside directors of its choosing to subsidiary boards.

2.3 Industry

In a well-known article on the structure of Japanese companies written almost two decades ago, Aoki (1990) argued that the substantive characteristics of Japanese production determine the structure of Japanese companies. Thus, the traditional Japanese corporate governance mechanisms grew up in industries characterised by slow, linear change. Building upon Aoki's theory, Gilson and Milhaupt argue that a company's decision to move to the committee system may be driven by its particular circumstances. Specifically, the committee system may be suitable for companies that (a) are engaged in industries with particular characteristics, or (b) have large foreign investment or are listed on a foreign exchange (Gilson and Milhaupt, 2005, pp. 362–4).

Gilson and Milhaupt identify electronics as a fast-moving industry that requires a flexible governance structure able to respond quickly to market changes. They suggest that the committee system is suited to the electronics industry because outside directors, without a 'lifetime investment in a company's particular infrastructure', are faster at responding to changes (Gilson and Milhaupt, 2005, pp. 362–3). By definition, grey directors do not fit this description, so the validity of this argument depends upon an individual company's use of outside directors. However, other elements of the committee system might contribute to managerial flexibility. The separation of the executive from the board of directors, for example, might give executive officers the managerial freedom to respond quickly and effectively to the market. Furthermore, the improved monitoring mechanisms of the committee system may also make it suitable for companies in industries, such as the finance industry, that require strict regulation. On the other hand, a company's ability to perform well in a particular industry may be unrelated to its corpo-

rate governance structure. It may simply be a result of employing highly skilled people in management positions. The factors influencing corporate performance are too varied to suggest that committee system adoption in certain industries will improve corporate performance.

Companies with large foreign investments or those that are listed on foreign exchanges, however, are likely to be valued higher under the committee system because foreign investors are more familiar with, and therefore have greater confidence in, that system (Gilson and Milhaupt, 2005, p. 363). This is especially so with investors from countries which employ corporate governance structures similar to the Japanese committee system, such as the United States, the United Kingdom, Canada, and Australia (Puchniak, 2003, p. 55; Australian Stock Exchange (ASX), 2003). Moreover, there is no reason why similar reasoning cannot be applied to the Japanese market. A company might also be valued higher in the domestic market by adopting the committee system if Japanese investors have greater confidence in that system than the statutory auditor system. The fact that a number of high-profile companies, such as Resona Bank and Shinsei Bank (formerly the Long Term Credit Bank), have adopted the committee system after a crisis suggests that this is in fact the case (Tsuru, 2003; Tett, 2004). However, it remains to be seen exactly to what extent the mere fact of adoption of the committee system will improve a company's market valuation.

2.4 Executive Officers

Under the committee system, a new position of executive officer was created to separate the executive management of the company from the board of directors (Company Law, art. 402). In theory, the executive officer role increases (or at least maintains) the flexibility of management despite the stricter monitoring imposed by the three committees and the outside directors. Gilson and Milhaupt do not address the executive officer system, but it warrants discussion because it is a key element distinguishing the committee system from the statutory auditor system. On paper, the increased managerial flexibility under the executive officer system and improved monitoring by the committees and outside directors is the committee system's greatest advantage over the statutory auditor system.

The requirement to establish the three committees with a majority of outside directors on each committee undoubtedly gives the committee system stronger monitoring powers than exist under the statutory auditor system. Monitoring, however, is only one part of the corporate governance equation. There is no overall corporate governance advantage to improved monitoring if it detracts from management's ability to manage efficiently and effectively. The executive officer system maintains managerial flexibility in the same way

that the separation of the board of directors from the board of statutory auditors does under the statutory auditor system. It allows the improved monitoring mechanisms to function effectively without hindering managerial freedom.

The effectiveness of the executive officer system might be hampered, however, by the fact that the law allows a director to concurrently serve as an executive officer (Company Law, art. 402(6)). This makes it possible for a company to bridge the gap between directors and officers and compromises the flexibility enhancements provided by their separation. Indeed, Cambridge University Professors John Buchanan and Simon Deakin (2007, pp. 20–21) concluded in their own recent empirical study that, although there has been some formal demarcation of supervision and execution in Japan, 'too many directors are still executives for this to be seen as a fundamental shift' in corporate governance. This provision of Japan's *Kaishaho* legislation undoubtedly reflects the status quo in the nation's corporate structure, whereby the directors of a company represent various divisions of the company. Its existence serves to lower the barriers for a company considering moving to the committee system because it can do so without having to drastically alter its corporate organisational structure. This undermines one of the key advantages the committee system provides. If a company maintains the separation of officers and directors it is likely to achieve both improved monitoring and managerial flexibility.

3. EMPIRICAL STUDY ON THE EFFECT OF COMMITTEE SYSTEM ADOPTION

There is no case law relating specifically to the committee system. Even if the courts had addressed the committee system, the resulting judgments would not have answered the legal questions of how the system is actually being used and how that use is perceived. Gilson and Milhaupt used event study methodology to determine market reaction to the first round of committee system adoptions in 2003 (Gilson and Milhaupt, 2005, pp. 366–9). There is also considerable empirical research on the United States corporate governance structure, upon which the Japanese committee system is patterned (Lin, 1996; Brickley, 1994; Byrd and Hickman, 1992; Kosnik, 1987). However, with the exception of the qualitative study by Buchanan and Deakin (2007), conducted roughly contemporaneously with this study but completely independently of it, the practical application of the committee system reform in Japan has not been empirically researched and studied. This section addresses this by introducing data collected between July and October 2006.

The data come from interviews conducted with professionals who deal with Japanese corporate governance issues in their occupations. More than 50

professionals were contacted, a total of 24 were interviewed, and 21 sets of responses were used in the empirical analysis. Of the latter, six sets of responses were from lawyers, five were from auditors, six were from bankers and institutional investors, and four were from ratings analysts. These professions were chosen for the empirical study because their work influences how the committee system is implemented by companies. Therefore, their impressions of how the system is being used, and whether it is accomplishing the reform's stated objectives, should provide rich data regarding the functional success of the reforms in Japanese corporate monitoring and flexibility. More specifically, respondents were selected with reference to: (a) the degree, frequency and context of their exposure to corporate governance issues, particularly committee system issues, in their work; (b) how long they have worked in positions with exposure to corporate governance issues; and (c) the number of respondents in each category relative to the other categories. Admittedly, the data set consists of a small-scale, non-random sample, so only tentative conclusions can be drawn. Nevertheless, Buchanan and Deakin (2007, p. 4) utilised similar methodology in their qualitative study. The combination of these two studies and the event study analysis designed by Gilson and Milhaupt (2005, pp. 366–9) provides a more comprehensive set of empirical data on the implementation and operation of the committee system.

The interview questions were designed to generate a comprehensive understanding of the differences in the respondents' approaches to their work and the outcomes of their work, depending upon whether they are dealing with a company with the committee system or a company with a statutory auditor. The questions specifically address the four areas of inquiry set out in Section 2 – outside directors, corporate groups, industry and executive officers – so that the theoretical speculations regarding the committee system can be tested against the empirical data. Respondents provided general perceptions of the committee system and also additional comments.[6]

3.1 The Data Set and Responses

3.1.1 Lawyers

Responses from six lawyers including in-house counsel and lawyers at private firms were included in the empirical results. The lawyers who answered the questionnaire advise companies on whether to adopt the committee system and on the effective implementation of the committee system to improve

[6] The responses do not necessarily reflect the views of the organisations with which the respondents are affiliated, even if the organisations are included in the citations for the interviews or questionnaires (detailed in the longer law journal article version of this chapter, referred to in the opening note).

monitoring and flexibility. Thus, as a group, lawyers' impressions of the efficacy of the system are directly related to the rate of uptake by companies and the way in which the system is used by client companies.

Outside directors The empirical and anecdotal data collected from interviews with the lawyers indicate a general perception that monitoring is not improved with the committee system because the outside directors are not truly independent. Satoshi Kawai, a corporate/mergers and acquisitions lawyer, suggests that outside directors from related corporations are not outside directors despite the legal definition of the term, and that there is no meaningful difference between companies with the committee system and statutory auditor companies. This dim view of grey directors is shared by other respondents in this category. This view implies that monitoring is strengthened where the outside directors in a company with the committee system are truly independent. Takashi Miyazaki, a private lawyer, points out the reality that truly independent outside directors are difficult to find in Japan.

Corporate groups The data from lawyers indicate that corporate group issues are intertwined with outside director issues. Kawai suggests it would be meaningless for subsidiaries under a parent company to adopt the committee system because the outside director positions would simply be filled by people from within the vertical group. None of the lawyer respondents suggested that this would be a positive development. There may, however, be some benefit in the parent company adopting the committee system because the legal definition of outside director precludes the appointment of representatives from its subsidiaries. It is therefore more likely that the outside directors of the holding companies would be genuinely independent. The same limitation does not apply to *keiretsu*, which are horizontally aligned.

Industry Two of the lawyer respondents suggested that companies that are listed on a foreign exchange or that have a substantial number of shares held by international investors are likely to receive a valuation benefit from adopting the committee system. This is especially relevant to United States and United Kingdom investors, who are likely to have greater confidence in the committee system because it is based upon the corporate governance structures of those countries.

The lawyer respondents suggested that companies in industries requiring managerial flexibility and speedy decision-making, such as electronics, would see improved performance under the committee system. This belief is based upon the technical separation of officers and directors in the committee system structure and a trend among companies with the committee system to have significantly fewer directors than statutory auditor companies of similar size.

Respondents also pointed out that some companies with the committee system perform badly while statutory auditor companies in similar industries perform well. Kawai suggests that flexibility and speedy response are dependent upon the ability of management. Miyazaki reinforces this view: 'Sony probably could have made speedy decisions even under the statutory auditor system.' Miyazaki also suggested that companies in the finance industry might be valued higher under the committee system due to the need for stricter monitoring in that industry.

Executive officers The lawyer data suggest generally mixed views on the significance of executive officer positions. Some responses indicate that it may be an advantage, especially in large companies, to have a CEO who can make decisions without referring to a large board of directors. Other responses suggest that the representative director position in statutory auditor companies possesses similar powers and there is little difference between the two. Overall, the lawyer respondents did not believe this was a determinative factor in enhancing corporate flexibility.

General perceptions Kaname Minakawa, an in-house corporate governance expert, believes that the committee system is not institutionally better or worse than the statutory auditor system. More important, states Minakawa, is the priority given to operational corporate governance under either system. Other respondents viewed the committee system reform as a neutral development with both positive and negative aspects.

3.1.2 Auditors

Responses from a total of five auditors were included in the empirical results. This number includes external auditors working at accounting firms, such as PricewaterhouseCoopers, and internal auditors working in Japanese corporations. Auditors assess the effectiveness of a company's internal governance and control systems, and make recommendations for improvement. Thus, as with lawyers, their views can influence whether, and how, the committee system is implemented by their client companies. In other words, auditors' impressions of the efficacy of the system directly impact the decisions of companies as well as the form of adoptions, such as whether grey or truly independent outside directors are appointed.

Outside directors The data indicate that auditors do see value in having outside directors on the board of a company. Hideki Akita, a certified public accountant at Misuzu Audit Corporation, stated that due to the existence of outside directors in companies with the committee system the 'internal checks are much stronger, and there is a feeling of safety'. However, as with the

lawyers, the majority of auditor respondents suggested that there was little value in having grey outside directors, because this weakens the monitoring function of the committee system. Some auditor respondents stated that they would be 'more cautious' when auditing companies with grey outside directors.

Corporate groups The data indicate that auditors, like lawyers, believe the parent company plays an important role in an assessment of the effect of the committee system in a corporate group. Responses suggest that if the parent company adopted the committee system then internal checks within the corporate group would be strengthened. The same effect would not be achieved if only subsidiary companies adopted the committee system. Internal checks would also be strengthened if both the parent company and its subsidiaries adopted the committee system, but there was concern that the positions of outside directors within the subsidiaries would be filled by representatives from the parent company or elsewhere in the group.

Industry The data indicate consensus among auditors that a company's industry makes little difference to the effect of committee system adoption. As with lawyers, however, some auditors suggested that companies that are listed on foreign exchanges or that otherwise seek foreign investment may be valued higher by the market under the committee system because investors from the United States and the United Kingdom especially are familiar with and have greater confidence in that system.

Executive officers The data indicate that auditors believe there is little practical difference between a managing director in a statutory auditor company and a CEO in a company with the committee system, despite the technical separation of directors and executive officers under the committee system. This impression is based on the fact that the committee system does not prevent directors from concurrently serving as officers. Nevertheless, responses indicate that a company may receive a valuation benefit from the positive image created by the illusory separation.

General perceptions The auditor responses indicate that there are both positive and negative aspects to committee system adoption. Internal control systems are generally more effective under the committee system. Committee system adoption also fosters a positive public image because it is considered to be more transparent.

3.1.3 Bankers and institutional investors

Responses from a total of six bankers and institutional investors were included

in the empirical results. This number includes representatives from commercial banks, investment banks such as Nomura Securities, and investment fund managers such as Barclays Global. The work of the respondents in this category includes assessing a company's suitability for loans and investment, advising on investment strategies and representing shareholder interests. The bankers' and institutional investors' impressions therefore influence whether a company implements the committee system. Further, because financing is dependent upon their impressions, they will also indirectly affect the market valuation of a company.

Outside directors The data indicate that bankers and institutional investors strongly favour companies with outside directors. Some respondents stated that they prefer client companies and companies in which they invest to have a majority of outside directors, despite the legal minimum of just two outside directors for companies with the committee system. There were, however, mixed views on the level of independence of outside directors. One respondent had a negative view of grey outside directors and did not consider them to be independent at all. The majority believed, however, that the value of a grey outside director was dependent upon the company. It is positive if the company makes an effort to create a meaningful role for the outside director. The data from bankers and institutional investors also suggest that grey outside directors, especially those from parent companies, may be valuable because they are likely to have in-depth knowledge of the company as well as the influence to make action happen. Respondents warned, however, that the ability to make action happen is highly variable because the resulting action will not necessarily be in the interests of stricter monitoring.

Corporate groups The data from bankers and institutional investors indicate a common belief among these professionals that a company's inclusion in a vertical group or *keiretsu* is of little importance to the committee system. Respondents indicated that inclusion may have an impact on a company's corporate governance, especially if the company is a 100 per cent subsidiary, but such impact is unrelated to whether the company has adopted the committee system. Moreover, the data suggest that the value of outside directors is heavily dependent upon the attitude of the vertical group or *keiretsu* to corporate governance.

Industry The data indicate that a number of bankers and institutional investors believe that committee system adoption has no bearing on a company's performance in a particular industry. Nevertheless, one respondent remarked that, while committee system adoption is probably not more or less suited to any specific industries, he believed that an outside director would be

less effective in that role if the company operated in an industry with which outside directors were unfamiliar.

Executive officers The data from bankers and institutional investors indicate a near-unanimous belief that the existence of a CEO has no impact on the effect of committee system adoption. One respondent stated very succinctly that 'it is irrelevant to how investors exert influence on the company'.

General perceptions The banker and institutional investor respondents focused heavily on the issue of outside directors. There was little concern for other factors unless they impacted the function of outside directors. The majority of respondents believed that the mere fact that a company has adopted the committee system is unlikely to have a positive effect on the performance of that company. The real issue is how a company that has adopted the committee system then utilises that system. For the respondents in this category this issue essentially concerns the approach a company takes to the function of outside directors.

3.1.4 Ratings analysts

Responses from a total of four ratings analysts were included in the empirical results. All respondents were from private ratings firms, namely Fitch and Standard & Poor's. Ratings analysts evaluate the implementation of the committee system by different companies as part of a company's credit rating assessment. Their views are therefore highly important in relation to the market valuation and share price of a company with the committee system. In other words, if ratings analysts have a favourable impression of the committee system in improving monitoring and flexibility of the company from a statutory auditor system, this will translate into a higher rating and, in turn, a higher valuation for the company. In short, ratings analysts' impressions are crucial to the market valuation of the benefit of the reform.

Outside directors The data indicate that ratings analysts, like lawyers and unlike bankers and institutional investors, are sceptical of outside directors in the committee system. Pekka Laitinen of Fitch Japan views committee system adoption negatively if it is clear that the outside directors are merely a façade and the monitoring mechanisms are not working. Naoko Nemoto of Standard & Poor's Japan stated that she also prefers genuinely independent outside directors when rating a company with the committee system. However, responses suggest that ratings analysts are more willing than lawyers to give grey outside directors some leeway. According to Tatsuya Mizuno, also of Fitch Japan, it is not important whether or not an outside director is independent on paper. He is more concerned with the extent to which the company

values strong corporate governance and the level of vigilance that outside directors exhibit.

Corporate groups Responses suggest that the affiliation of a company with the committee system with a vertical group or *keiretsu* is of little concern to ratings analysts. There were differing reasons for this view. At least one respondent, Laitinen, expressed the view that *keiretsu* are gradually weakening. In contrast, Nemoto suggested that most Japanese companies are affiliated with other companies in some way even if they are not technically part of a corporate group. There was consensus that it is better to assess the governance of companies individually, especially since attitudes toward corporate governance can vary among companies within a corporate group.

Industry The responses indicate that the industry to which a company with the committee system belongs is not a significant consideration for ratings analysts. As with the lawyers, some respondents expressed the view that the committee system may be suited to industries that require strict monitoring or quick responses from management. Moreover, Mizuno suggested that the committee system gives an impression of strong corporate governance, which may be an advantage in industries where consumer reaction to management is important. Unlike the lawyers, however, none of the ratings analysts specifically stated that the committee system might be suitable for companies with large foreign investment.

Executive officers The data indicate that the title of executive officer is of little consequence to ratings analysts. Whether a CEO is viewed as actually having an effect on a company's governance is of greater importance. Nemoto believes that a CEO under the committee system makes little difference because the decision-making and monitoring functions still overlap. This is a weakness in Japanese corporate governance and an area that is still developing for both companies with the committee system and statutory auditor companies. Only Laitinen is inclined to view the CEO as a positive factor. He concedes, however, that it is only a minor consideration and not, on its own, determinative in the ratings process.

General perceptions A majority of ratings analysts expressed a qualified opinion that the committee system reform was more positive than negative. Ultimately, however, a company's rating is dependent upon many factors, and committee system adoption by itself is not determinative. Nevertheless, Laitinen believes the committee system reform may have triggered improvements in Japanese corporate governance, especially transparency in corporate governance, and that these improvements are not limited to companies with

the committee system. Finally, Mizuno suggests that the committee system is perceived by the public to be a stronger corporate governance model. As a result, companies in crisis tend to adopt the committee system for the cosmetic effect of reassuring the market.

3.2 Overall Analysis of the Empirical Data

In this section, I analyse the impressions of the committee system collected from lawyers, auditors, bankers and institutional investors, and ratings analysts. I use these data to test the accuracy of the theoretical speculations in Section 2 and reach conclusions as to how the committee system is actually being used. Specifically, I address whether committee system adoption results in improvements to monitoring mechanisms or managerial flexibility, or leads to a higher market valuation. In Section 4, on the basis of these conclusions, I briefly discuss areas for reform of the law and improvements to committee system implementation.

I analyse the empirical results as a whole because decisions about adoption and implementation of the committee system will be influenced by the impressions of more than one of the respondent categories. As an example, although the impressions of lawyers and auditors will have a direct impact upon the rate of uptake, the impressions of bankers and institutional investors, and ratings analysts, can also indirectly impact uptake if managers believe that their company will be valued higher under the committee system. Nevertheless, the data from a particular respondent category or categories are emphasised where they are of specific relevance in the analysis.

3.2.1 Outside directors

There is evidence in the empirical results to support Gilson and Milhaupt's argument that the loose definition of outside director does not ensure outside directors are divorced from the interests of either controlling shareholders or other stakeholders. Respondents from all categories value truly independent outside directors over grey outside directors. It was even suggested that grey outside directors are not outside directors. The impressions of auditors in this regard are particularly relevant because a key element of their job is to ensure effective internal monitoring. The impressions of ratings analysts and bankers and institutional investors are also significant because they indicate a belief that the presence of outside directors increases shareholder value.

The empirical data indicate that most respondents are concerned that outside director positions are not used to improve monitoring. This suggests that companies with the committee system do appoint grey outside directors, even though this would not provide a monitoring advantage over the statutory auditor system, and, therefore, that there are reasons for adopting the commit-

tee system other than having independent outside directors. One possibility is better organisation of corporate groups. Another possibility, as some respondents suggest, is gaining a market valuation advantage from giving the illusion of stronger governance.

There is empirical evidence, however, to support Puchniak's argument that grey outside directors can strengthen a company's governance. At least two respondents suggested that grey outside directors often have a constructive understanding of the company's business and the seniority to exert influence and make action happen. This might translate into a capacity to monitor management more effectively. This view is supported by Buchanan and Deakin's conclusion (2007, p. 11) that outside directors are seen as having an important advisory role but there is a perceived limit to their ability to effect action on strategic matters due to a deficiency of knowledge and experience of the internal workings of the company. However, the ability to make action happen can be both positive and negative depending upon the interests a grey outside director serves. Whether or not a grey outside director strengthens a company's governance is therefore dependent upon the circumstances of the individual company. The same could be said even of truly independent outside directors.

As a result, narrowing the legal definition of outside director to exclude grey outside directors not only is unlikely to help defeat stakeholder tunnelling but may actually eliminate opportunities to strengthen corporate governance. Instead, efforts might be made to encourage, rather than force, companies to appoint truly independent outside directors. Further, companies might be encouraged to take corporate governance issues seriously and create corporate environments in which grey directors will enhance, rather than compromise, monitoring. To achieve these goals, reference can be made to the US, UK, Canadian and Australian experiences where the recommendations of major pension funds, corporate governance organisations, and stock exchanges have brought about large contingents of independent directors on corporate boards (ASX, 2003).[7] Interestingly, some respondents suggested that the committee system reform itself is serving to increase awareness of corporate governance.

Regardless of the nature of the director, it is worth putting in place measures to prevent outright abuse of the system. Rather than narrowing the legal definition of outside director, this would be better achieved through criminal and civil penalties on particular activities. Even truly independent outside directors (and others) may engage in activities intended to be prevented. Imposing penalties instead of narrowing the definition would not

[7] See also CalPERS (2006), 'US Corporate Governance Core Principles and Guidelines', <http://www.calpers-governance.org/principles/domestic/us/page01.asp>.

reduce the number of eligible outside directors, and this is especially relevant in Japan, where the pool of candidates is already shallow.

Finally, evidence suggesting that outside directors can improve monitoring and contribute to defeating stakeholder tunnelling undermines Gilson and Milhaupt's argument that stakeholder tunnelling is a cultural characteristic of Japan. All categories indicated a preference for truly independent outside directors. This suggests a belief that truly independent outside directors do strengthen monitoring, which contradicts the Gilson and Milhaupt argument. Although this evidence does not eliminate the possibility of stakeholder tunnelling being culturally embedded in Japan, it at least suggests it is not a major concern to those responsible for implementing, regulating and evaluating the committee system.

3.2.2 Corporate groups

The auditor and lawyer results – significant for the discussion on corporate groups because they largely relate to methods of implementing the committee system – indicate that vertical groups have an advantage over *keiretsu* under the committee system. However, it is not a flexibility advantage resulting from the parent company's ability to appoint outside directors to subsidiaries. On the contrary, it is because, by definition, a company's outside directors cannot be associated with one of its subsidiaries. Thus, there is a greater likelihood that the outside directors of a parent company will be genuinely independent, because its pool of grey outside director candidates is reduced. A *keiretsu*, on the other hand, is characterised by horizontal cross-shareholdings rather than parent–subsidiary relationships. As a result, the pool of outside director candidates from within the group is virtually unlimited. Furthermore, the auditor results indicate that where there is a controlling company in a group there is likely to be more thorough internal regulation throughout the group. This suggests that the existence of a controlling company does improve corporate governance, at least from a monitoring perspective.

However, the positive aspects of a vertical group with a controlling company do not appear to extend to the ability to enhance group cohesion under the committee system. Theoretically, the parent of a committee system company has a flexibility advantage compared with the parent of a statutory auditor company because it can attain effective control of the subsidiary via its committees – especially the nomination committee – by appointing as few as two outside directors. The parent of a statutory auditor company, in comparison, would need to appoint a majority of the subsidiary's directors to achieve a similar level of control. The empirical data suggest, however, that any flexibility advantage a parent company may obtain from the ability to control a subsidiary's nomination committee is largely ignored, because the outside directors are not independent. In other words, the respondents discount the

value of outside directors from within a corporate group, because they are grey outside directors, *before* they assess how the grey directors can enhance the flexibility of group management.

Overall, the empirical data suggest there is no flexibility advantage in a corporate group adopting the committee system. Contrary to Gilson and Milhaupt's argument, any flexibility gained from the enhanced group cohesion is undermined by a perceived reduction in monitoring effectiveness caused by the appointment of grey directors. This is a zero-sum equation. There is no way to accommodate both objectives without also compromising both.

Interestingly, the data indicate greater concern for the monitoring side of this equation. Maintaining monitoring standards in corporate governance is certainly important, but the empirical data suggest a lack of appreciation for the group cohesion benefits available to a vertical group under the committee system. The corporate group scenario is an example of how grey outside directors can play an important flexibility role, in addition to a monitoring role. The recommendations of influential institutions, among other methods, might also be used to raise awareness of this additional function of grey outside directors.

3.2.3 Industry

The empirical data support the view that committee system adoption does not heavily influence corporate performance in a particular industry. A few respondents suggested that companies in industries requiring swift managerial response, such as the electronics industry, or strict monitoring, such as the finance industry, might attain those capabilities under the committee system. The consensus in all respondent categories, however, was that the committee system will not necessarily give a company the attributes required to perform well in an industry. Considering that market valuation is a key indicator of corporate performance, it is significant that many ratings analysts, bankers and institutional investors held this view. An oft-stated reason for this view is that some companies with the committee system are performing badly while statutory auditor companies in similar industries are performing well, and vice versa. This suggests that other factors, such as the quality of management, play at least as important a role in a company's performance in a particular industry as adoption of the committee system.

The lawyer and auditor respondents indicated that companies in industries that have high levels of foreign investment, or are listed on a foreign exchange, would be valued higher for adopting the committee system. The foreign investors' familiarity with the committee system of the US and UK markets, in particular, increases their confidence in companies with the committee system and consequently how much they will pay for those companies. The fact that lawyers and auditors have this impression may be one reason why the uptake of the committee system has been high among companies with foreign

investment (Japan Corporate Auditors Association, 2006). Moreover, the fact that ratings analysts, bankers and institutional investors do not have this impression explains why, according to Gilson and Milhaupt's market reaction study, those companies' market valuations have not changed significantly (Gilson and Milhaupt, 2005, pp. 366–9). Interestingly, one ratings analyst, in addition to some auditor respondents, indicated that there was a public perception in Japan of the committee system as a stronger and more transparent corporate governance structure. This impression, however, is not supported by Gilson and Milhaupt's market event study. Thus, even if the committee system is perceived, both in Japan and overseas, to be better than the statutory auditor system, it is unclear whether that will result in higher market valuation.

3.2.4 Executive officers

The empirical data indicate that executive officers provide little flexibility enhancement to a company's governance. Only a few of the lawyers – and none of the respondents from the other categories – suggested that a company with the committee system would achieve greater managerial flexibility from the separation of officers from directors. However, the data also suggest there is a lack of appreciation in the market of the value of this separation. This is exhibited in two forms. First, at the very least there is a lack of understanding of the function the separation is intended to serve. This is indicated in the results from bankers and institutional investors, where there was a near-unanimous belief that the existence of a CEO has no impact on the performance of a company with the committee system.

Furthermore, some of the lawyer responses suggest that executive officers have similar powers to directors in statutory auditor system companies and there is little difference between the two. Second, in practice the separation of directors and officers in the committee system is not maintained. This is a key reason given by a number of respondents for why they place little value on executive officers in the committee system. The main cause appears to be that directors can concurrently serve as executive officers under the Company Law. An obvious solution to this problem would be to abolish the provision allowing directors to serve concurrently as officers. Some companies, however, may move to the committee system only for the cosmetic effect, while essentially retaining a corporate governance model similar to the statutory auditor system. Far from persuading these companies to put in place strict separation of directors and officers, the abolition of that provision may simply cause them not to adopt the committee system.

A more effective method would be to encourage those companies to enforce the separation of directors and officers voluntarily. Again, the recommendations of influential institutions might achieve this objective. Ironically, the goal might also be achieved, albeit indirectly, by encouraging committee

system companies to appoint truly independent outside directors in greater numbers. The independence of the outside directors would enhance the company's monitoring mechanisms and that, without effective separation of directors and officers, would eventually impede managerial flexibility. This, in turn, would give a company an incentive to separate directors and officers of its own accord.

4. CONCLUSIONS

In 2002, a number of high-profile Japanese companies moved to the new committee system corporate governance structure, despite scandals surrounding the US system upon which it was modelled. Shortly thereafter, Gilson and Milhaupt speculated on the strategies of those companies that moved to the new system. This chapter sought to test those strategies, and the overall effect of the operational committee system law reform, by assessing four aspects of the committee system that distinguish it from the statutory auditor system: outside directors, corporate groups, industry and executive officers. It did this by collecting and analysing empirical data on the impressions of those indirectly charged with implementing and evaluating the committee system reform: lawyers, auditors, bankers and institutional investors, and ratings analysts.

The results indicate that the operational committee system provides few advantages over the statutory auditor system. There is considerable scepticism about the monitoring ability of outside directors due to the loose definition of that term. Moreover, despite the monitoring and flexibility benefits grey outside directors can bring to a company with the committee system, their value is unappreciated because they are not truly independent. This is most evident in relation to corporate groups, where efforts to strengthen group cohesion are undermined by the necessary use of grey outside directors. Further, the separation of executive officers from the board of directors does not enhance flexibility, because the law allows directors to serve concurrently as officers. There is also no strong evidence that the committee system provides companies with the capabilities to perform well in specific industries, or that the committee system's positive image contributes to higher market valuation.

The solution, however, is not further reform of the committee system law. Narrowing the definition of outside director, for example, would simply prevent companies from deriving both monitoring and flexibility benefits from grey outside directors without necessarily improving the monitoring mechanism of the committee system. Similarly, changing the law to prevent directors of companies with the committee system from concurrently serving as executive officers is only likely to reduce the committee system's attractive-

ness. On the other hand, the committee system's monitoring mechanisms might be improved by encouraging companies with the committee system to appoint truly independent outside directors in greater numbers, and to create environments in which grey outside directors will monitor effectively. The adverse effect this strengthened monitoring would have on managerial freedom might also indirectly encourage companies with the committee system to separate executive officers from directors more strictly.

The committee system is not a panacea for all corporate governance and corporate performance woes. That much is evident from the many poor-performing companies that have adopted the committee system. The committee system does, however, resemble a placebo. It is perceived to be a stronger and more transparent corporate governance system, even though the empirical data suggest that in practice it is generally neither stronger nor more transparent than the statutory auditor system.

The legal structure of the committee system nevertheless offers advantages over the statutory auditor system. It offers stronger monitoring mechanisms in the form of mandatory committees and outside directors, and it separates officers and directors to ensure those monitoring mechanisms do not impede managerial flexibility. It also offers a means of enhancing the organisational flexibility of corporate groups. These monitoring and flexibility advantages, however, are presently misunderstood and misapplied. Implementing the committee system in a way that capitalises on these advantages may bring an increase in market valuation that mere adoption will not.

7. Streamlining the market for corporate control: a takeovers panel for Japan?

Geread Dooley

Japan Inc. has been shaken, its foundations jolted. The person primarily responsible is Takafumi Horie. In 1996 Horie dropped out of Japan's prestigious University of Tokyo and founded Livin' on the Edge, a website design consultancy company, with just US$52 000. Employing an unheralded mergers and acquisitions (M&A) strategy the brash entrepreneur engineered the purchase of more than 50 companies. Such raw capitalism and entrepreneurial vitality has rarely been seen in post-war Japan. By December 2005 the company, now known as 'Livedoor', had a market value of US$7 billion (based on annual sales of just US$661 million for 2005). Horie had acquired celebrity status. Spurred on by Horie's aggressive manoeuvres and abrupt success, the unthinkable has occurred: takeover activity is on the rise in Japan – a country famous for the illiquidity of its stock exchange and tightly held companies.

Unintended consequences have occurred. Japanese corporate conventions such as relationship-based business decisions and the veneration of organic growth have been challenged. Corporate Japan, some say intent on preserving the status quo, has used Horie's challenge as a pretext for implementing management-preserving corporate rules, including versions of the notorious US-style 'poison pill' defences (Milhaupt, 2005a, p. 2171). The poison pill defence – especially in the Anglo-Commonwealth tradition – is often regarded as a pro-management device capable of locking-in insular boards, prone to inhibit the market for corporate control. Undeterred, Japanese lawmakers have partially endorsed the poison pill. As outlined in this volume's Chapter 8 by Kamiya and Ito, a key development was the joint release of the 'Guidelines Regarding Takeover Defences for the Purpose of Protection and Enhancement of Corporate Value and Shareholder's Common Interests' ('Guidelines') by the Ministry of Justice (MoJ) and the Ministry of Economy, Trade and Industry (METI) on 27 May 2005. Aware of the reputation the poison pill holds, however, the Guidelines emphasise the importance of the surrounding corporate infrastructure – namely shareholders, independent directors and the courts – to act as counterbalancing mechanisms to managers who engage in

self-protection tactics and stifle market activity. Yet some argue that in Japan such infrastructure has not developed to the level required to fulfil this role (Gilson, 2004, p. 21).

In Australia the Takeovers Panel has recently become the primary forum for resolving takeover disputes (Corporations Act 2001 (Cth) s. 657A(1)). It aims to bring speed, specialist expertise and commercial pragmatism to the dispute resolution process, supplanting the courts during takeover battles and permitted to base its decisions on the broader 'spirit of takeover rules' (Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1999 (Cth), p. 38). Its effectiveness in facilitating negotiated outcomes to disputes is indicative of this approach (Calleja, 2001, p. 328). The Takeovers Panel also has a significant policy-making role. This is reflected in its publication of decisions, the release of Guidance Notes, the provision of consultations, the holding of 'Panel Days' and the providing of Panel post-mortems, all of which provides direction for market participants. Since its introduction in 2000 there have been encouraging results for the Panel (Armson, 2005, p. 665). Generally, the Australian business community, the courts and its numerous advocates have openly praised the Takeovers Panel for achieving what it set out to do: creating a healthier takeover market, even in a country with a significant tradition of 'blockholders' and less active institutional investors compared with the UK (Nottage, 2008b).

The Japanese corporate environment seems ripe for an innovation such as a takeovers panel based on the Australian model. Japan's takeover market is still in its infancy. The Guidelines endorsing the poison pill defence are the first major regulatory change to the market in response to the rise in takeover activity. Based on those guidelines it is evident that policymakers are emphasising the surrounding corporate infrastructure, an infrastructure that some argue is insufficient at present to ensure that a healthy takeover market comes to fruition. This chapter suggests that a takeovers panel, through undertaking a nurturing role, can be a positive influence on poison pill implementation and more generally on Japan's takeover market. The specialist panel, as in Australia, might act as the main forum for complex issues such as the legality of 'poison pill' defence strategies; it may also encourage shareholders and company directors to fulfil their required functions through its policy-making role.

This chapter is largely motivated by the recently released Guidelines. There has already been discussion as to whether the Guidelines are the right choice. Milhaupt (2005a, p. 2171) and Gilson (2004, p. 21) have speculated that the Guidelines may impact negatively upon the Japanese M&A market. Yet there has been little comment on how Japanese lawmakers and market participants might be assisted in ensuring the Guidelines have the impact that the lawmakers intended, to positively influence the M&A market.

Before proceeding, a normative admission is in order. This chapter adopts the view of the Corporate Law Economic Reform Program (1997), Proposals for Reform: Paper No. 4, *Takeovers – Corporate Control: A Better Environment for Productive Investment* (CLERP paper), that takeovers are beneficial as a tool to generate 'improved corporate efficiency and enhance management discipline leading ultimately to greater wealth creation'. There are arguments both for and against the CLERP paper's position and the validity of those views is beyond the scope of this chapter. It is therefore not proposed that takeovers in Japan be openly encouraged; however, at the very least they should not be unnecessarily inhibited. Separately, it should be noted Takeovers Panels are also in place in New Zealand, Ireland and most notably the United Kingdom since 1968.

This chapter is organised as follows. Section 1 briefly outlines Japan's takeover market (elaborated further in Chapter 9 by Pokarier) and its evolving regime regarding takeover defences (elaborated further by Kamiya and Ito in Chapter 9). An analysis of the Guidelines suggests a flawed reliance on surrounding corporate infrastructure. Section 2 focuses on the Takeovers Panel in Australia. A brief overview of the Panel's aims, roles and procedure elucidates why the Panel has been widely heralded a success in Australia. Section 3 attempts a Panel 'transplant', explaining how a takeovers panel might function in Japan to alleviate the flaws illustrated in Section 1. This chapter tentatively concludes that the Australian model has potential for Japan, as it provides a mechanism through which an expert body can facilitate takeover dispute resolution processes and better inform market participants of the regulatory system in which they operate.

1. TAKEOVERS IN JAPAN

1.1 The Livedoor Shock

In 2001, one commentator remarked: 'There is no market for corporate control in Japan and there is not likely to be one' (Fligstein, 2001, p. 187). The comment seemed well founded. In the 1990s there were on average only 500 M&A cases per year. During 2001, despite Japan being the world's second largest economy, the Japanese M&A market accounted for only 3.5 per cent of M&A cases worldwide. However, by 2004, there had been a 400 per cent increase in the number of M&A cases, to 2211, from a decade earlier. On the other hand, hostile takeovers remained exceedingly rare (Corporate Value Study Group, 2005, pp. 14–15).

On 8 February 2005 the hostile M&A market was awoken. Livedoor announced that it had purchased a 29.6 per cent interest in Nippon

Broadcasting System Inc. (NBS). NBS was a radio broadcasting company, an integral part of the Fujisankei Group and one of the largest media conglomerates in Japan. Combining this with existing shares held in NBS, Livedoor Co. at this point had a 38 per cent interest in the company. It was further announced that Livedoor planned to purchase all outstanding shares in NBS. Already in motion, though, since 18 January 2005 was a friendly takeover bid for NBS by Fuji Television Network Inc. (Fuji), the virtual head of the Fujisankei Group, which had already been approved by NBS directors. Enter Horie and Livedoor. The fact that NBS owned 22.5 per cent of Fuji added to the unexpected. If Livedoor could successfully acquire control of NBS it would become the largest single shareholder of Fuji and acquire management control over the media conglomerate.

The NBS board immediately decided to issue warrants to Fuji to block Livedoor from acquiring a majority of NBS's shares. Livedoor responded by seeking a preliminary injunction from the Tokyo District Court to stop NBS from issuing the warrants to Fuji (immediately seeking an injunction from the courts might be seen as a 'typical' Japanese business response). The Tokyo District Court granted the preliminary injunction, deeming the warrants 'grossly unfair'. The Court found that its main purpose was to maintain the company's current business framework policy, including control by the incumbent management (16 March 2003, 1173 Hanrei Times, p. 140). The Tokyo High Court affirmed the decision (23 March 2005, 1173 Hanrei Times, p. 125). Ultimately Livedoor acquired the majority only to relinquish it in a settlement agreement on 18 April 2005. Livedoor agreed to sell its NBS shares to Fuji at 6,300 yen per share, about the average price it paid for the shares. In return, Fuji obtained a 12.5 per cent stake in Livedoor for a capital infusion of approximately US$440 million and the three companies established a joint committee to explore related ventures.

Livedoor's hostile bid was a watershed case. Horie had thrust hostile M&A into mainstream Japan. As the battle between Livedoor Co. and NBS played out in the courts, its effects overflowed into the Japanese psyche. Livedoor 'struck a deep chord in the Japanese consciousness – not only on a corporate level, but politically and socially as well' (Milhaupt, 2005a, p. 2181). Japan was reeling from the challenges Livedoor Co. offered. Foremost, Livedoor Co. represented the shock of the new, personified by the brash Horie himself. He debunked corporate stereotypes, a college dropout who often wore just a T-shirt and jeans and was entirely disconnected from the suited gerontocracy that dominates Japan's corporate elite. Livedoor's business methodology was profoundly unorthodox (Milhaupt, 2005a, p. 2181). It included share splits to boost share prices, off-market share purchases to avoid disclosure requirements and the use of tactical litigation. All were an abrasive departure from the tranquil norms that had previously governed.

The challenge was also acutely evident to Japan's corporate managers. A survey conducted after the Livedoor case revealed that 70 per cent of large firms in Japan were concerned about the threat of hostile takeovers (*Asahi Shimbun*, 30 April 2005, p. 1). Shortly after, more than a hundred companies, including Japanese multinationals such as NEC, Sony and Toyota, sought to implement some form of takeover defence measures in response to the Livedoor case.

Aware that many firms were undervalued, yet heavily asset laden, the media soon began to exploit corporate Japan's anxiety. Focusing on the role that US investment bank Lehman Brothers played in financing Livedoor's bid, the *Keidanren* (Japan Business Federation) even mooted that Lehman Brothers was not dissimilar to US Commodore Perry's 'Black Ships' of 1853, and that a new wave of 'foreign predators' was coming to Japan. Although this comparison was largely political propaganda, it successfully captured the hysteria sweeping the boardrooms of Japanese corporations.

1.2 Why are Takeovers in Japan now a Reality?

In reality, the Livedoor shock was the result of the environment in which it occurred. A series of legal and non-legal factors, set in motion by the bursting of Japan's 'bubble economy' in 1990, essentially combined to facilitate the dramatic events of 2005.

A major impetus was the rapid dissolution of cross-shareholding *keiretsu*, the pattern of majority reciprocal share ownership by Japanese corporations (Tsuru, 2005). The motivation for such shareholding patterns is corporate cooperation and mutual support between companies. It also effectively nullifies any possibility of a takeover bid by withdrawing a large percentage of the stock from active trading, thus making it more difficult for a potential acquirer to gain the necessary shares to form a majority ownership (Henderson, 1991, p. 283). Over the period 1996–2005 the percentage of cross-shareholdings fell by more than 10 per cent. Conversely foreign ownership rose from 6 per cent in 1993 to almost 23.5 per cent in 2005. The net result has been greater fluidity in Japanese share markets.

Changes in social norms have also played a significant role. Traditionally, the company has held a unique place in the Japanese psyche. It was regarded by many management boards and employees as an extension of their families (as critiqued in this volume's Chapter 3 by Wolff). A corollary was that, for many, M&A constituted an attack on the 'company's family-like composition' (Milhaupt, 2001, p. 2090). However, the recession that plagued Japan throughout the 1990s brought considerable change. Part of that change has been the gradual erosion, among other things, of social norms such as company loyalty. Japanese companies, after continued rapid growth for three decades, were at

last exposed as mortal structures. As a result, the company's aura has now somewhat receded and has been replaced by a more realistic view of market forces and subsequent company vulnerability. Part of that realism is the mechanism of takeovers, including hostile bids (Goldman, 1990, p. 392).

Moreover, there have been important changes to Japan's corporate law. As outlined in this volume's introductory chapter, key reforms were made to areas such as board structure (elaborated in Lawley's Chapter 6), directorial duties and personal liability, executive compensation and organisational flexibility. These changes have contributed significantly towards the increased levels of M&A activity. Legal reforms 'have altered the incentive environment for transfers of corporate control, facilitating deals motivated by Japan's new economic realities' (Milhaupt, 2005a, p. 2189).

In summary, although Horie can be credited as the catalyst for the dramatic events of 2005, a markedly changed business climate provided the ideal setting for his bold plans to be carried out. Fundamental changes to the corporate environment and the laws that govern it created conditions where hostile M&A are not only a possibility but have become a reality, even though no hostile takeover of a major Japanese company has yet been successfully completed (Puchniak, 2008).

1.3 The Guidelines: the Government's Response

Amid the rash of legislative reforms since the mid-1990s, the regulatory regime governing takeover activity received relatively little specific attention. However, METI and MoJ jointly released their Guidelines on 27 May 2005, and are now embarking on revisions.[1] The Guidelines fall within the ubiquitous system of *gyosei shido* (government administrative guidance). Administrative guidance is the informal enforcement of regulatory objectives. It covers a variety of actions by which the administrators influence relevant parties through extra-legal means premised on voluntary compliance (Nakagawa, 2000). The Guidelines are closely based on a METI-sponsored Corporate Value Study Group Report ('Corporate Value Report'), also released in May 2005.[2] The Corporate Value Report's aim was to construct an

[1] In late 2007 METI announced that the Guidelines will be amended, with the revision process to commence in Spring 2008. See 'Guidelines on takeover defenses to be reworked', Bloomberg, 14 September 2007.

[2] The Corporate Value Group, composed of legal experts and business representatives, was established in September 2004. The report was based on extensive research and consultations with experts regarding Anglo-American takeover defences and legal precedents. See also Chapter 8, by Kamiya and Ito, in this volume.

appropriate government policy response to hostile takeover activity in Japan (Corporate Value Study Group, 2005, p. 6).

Together the Guidelines and the Corporate Value Report represent the government's first response to the increasing trend of takeovers in Japan. The Corporate Value Report recognises that, whilst M&A can be a catalyst for managerial innovation and improved corporate efficiency, there is sometimes a need to curb takeover activity, such as unsolicited bids, which can negatively skew the market and managerial behaviour (Corporate Value Study Group, 2005, p. 33). The government's response therefore endorses US-style defensive measures as a vehicle to avoid raw and potentially market-damaging M&A activity (Corporate Value Study Group, 2005, p. 68). Furthermore, there seemed to be an implicit approval of Delaware takeover jurisprudence, home of the poison pill defence (Milhaupt, 2005a, p. 2196). While the Guidelines are not legally binding, it was also expected that the enunciated principles would be highly persuasive in the evolving case law on the legality of takeover defence measures (Corporate Value Study Group**,** 2005, p. 24).

Importantly, the Corporate Value Report suggests that such defensive measures are legal in Japan and do not violate the engrained principle of shareholder equality (*Kaishaho*, Company Law, art. 109). One 2001 Commercial Code amendment seems to reinforce the Corporate Value Report's view on the legality of the defence measures (Company Law, art. 236(1)(7)). The amendment permits the issuance by the board of directors, in most cases without shareholder approval, of an option-like financial instrument called a stock acquisition right. This amendment appears to allow corporations in Japan to replicate a US-style poison pill defence (Corporate Value Study Group, 2005, p. 79).

The Guidelines state that companies implementing defensive measures should observe the following three principles. First, companies should adopt, use or redeem takeover defence measures for the purposes of protecting or enhancing 'corporate value' as well as the common interests of all shareholders as a whole (METI and MoJ, 2005, p. 5). The Corporate Value Report (2005, p. 87) explains that as a general rule this is a decision for shareholders to make at a general shareholders' meeting. However the Report also recognises that in many cases there will be a need for prompt company decisions and a shareholders' meeting may not always be possible. The Report, therefore, envisages company management as being the body primarily responsible for these decisions. To assist management in the decision-making process, the Report sets out a 'corporate value standard' as a means to determine when a defence measure is reasonable. Company management would examine: (i) whether there is an existing threat to corporate value; (ii) whether the defensive measures are proportionate to the threat; and (iii) whether its own actions are prudent and appropriate. The Report sets out examples that it expects will satisfy each of the three points in the corporate value standard.

Second, the Guidelines recommend that it is prudent for corporations to disclose the specific details of takeover defensive measures at the time they adopt them to allow shareholders to make appropriate investment decisions. Further, the Guidelines suggest the takeover defensive measures should reflect the reasonable will of the shareholders (METI and MoJ, 2005, p. 5). In other words, the Guidelines require the takeover defensive measures to be adopted at a general meeting of shareholders or, if adopted by board resolution, to include a mechanism such as a proxy context that will allow the shareholders to redeem such measures.

Third, the Guidelines propose that takeover defensive measures should conform to the requirements of Japanese corporate law, including the principles of shareholder equality and the protection of property rights (METI and MoJ**,** 2005, p. 6). In addition the Guidelines propose management should put in place mechanisms to prevent possible company board entrenchment (METI and MoJ**,** 2005, p. 6). The Corporate Value Report outlines three devices that would be appropriate for fulfilling the final requirement: (i) evaluation by independent parties such as independent directors; (ii) inclusion of a 'chewable pill' clause or 'permitted offer exception clause', which would provide that defensive measures be redeemed if an acquisition proposal meets certain objective requirements established by the board in advance; or (iii) approval by the shareholders (Corporate Value Study Group, 2005, p. 96).

1.4 Reliance on Missing Infrastructure

In this way, the government began to clarify how takeover defences could be acceptable, yet corporate Japan still had to decide when and how it might adopt protective measures. Rightfully so, the Guidelines do not themselves address the obligations of a company board when a hostile bid is actually made. Unsolicited bids are fact-dependent, requiring them to be approached in a case-by-case manner (a view evidenced in the fact-intensive nature of Delaware takeover jurisprudence: Milhaupt, 2005a, p. 2209). However, as Gilson (2004, p. 30) has found in relation to US corporations, it is possible to analyse the motives that will be present when a company becomes a target. Generally three will be evident. The first is that target management may be acting out of self-interest. The poison pill is capable of locking-in insular boards to allow the current managers to maintain the status quo even though the bid may benefit target shareholders. The second is that the target board may use the poison pill as a bargaining tool to probe for a higher bid. And the third – closely related to the second motive – is that target management may attempt to stall a bid in the belief that an offer at a later period will be more advantageous to shareholders.

A corollary of this is that, while administrative guidance on the structure

that a poison pill should take is important, a more pressing issue comes to the fore. Who monitors corporate management to ensure the correct motivation is evident when a poison pill defence is implemented? As Gilson (2004, p. 31) points out, '[t]he critical operational question is the identity of the policeman'. Gilson, basing his findings on the operation of the poison pill in the US, concludes that three different institutions can and largely do ensure that management acts in a bona fide manner: independent directors, shareholders and courts (Gilson, 2004, p. 33).

Gilson's analysis is a useful starting point when considering the Japanese government's response. Just as lawmakers have essentially transplanted the poison pill structure from US jurisprudence, it appears they also envisaged a transferal of surrounding infrastructure to Japan. The Guidelines and the Corporate Value Report both make numerous references to the policing role expected by lawmakers of shareholders and independent directors (see for example Corporate Value Study Group, 2005, pp. 87, 96; and METI and MoJ, 2005, p. 5). Additionally the vague and highly fact-specific nature of the Guidelines indicates that lawmakers contemplated Japanese courts also playing a key monitoring role in the pill's implementation (METI and MoJ, 2005, p. 5). Subsequent Japanese case law, outlined in this volume's Chapter 8 by Kamiya and Ito, shows that this is proving to be true. In guiding further developments, this chapter questions, in sequence, the level of development of Japan's institutional structure relied upon in the Guidelines.

1.4.1 Shareholders

In the past decade shareholders in Japan have taken on a new presence in the share market (Nottage and Wolff, 2005). To begin with, the face of the Japanese shareholder has changed. Cross-shareholdings have fallen, while foreign investments have risen. Shareholders have also found more voice. Shareholder activism is on the rise, spurred on by recent legislative amendments permitting shareholders a greater corporate monitoring role. Between 1991 and 2000 approximately 490 derivative suits were filed. By comparison, in the 40 years prior to 1991 a mere 20 derivative suits were brought (Milhaupt, 2003, p. 12). Independent groups like ISS, an investor information service firm that advises foreign institutional investors, have also contributed to a more activist shareholder environment. During the 2005 round of Japanese company general shareholder meetings ISS opposed the proposal of takeover defence measures in seven companies.[3]

[3] Koyano, Taro, 'Poison pill defense not liked by all', *Daily Yomiuri*, 8 July 2005, p. 8.

These marked changes are reasons for optimism that Japanese shareholders have strengthened their position in corporate Japan. However, there are still grounds for concern. Despite decreases in cross-shareholdings, financial institutions and business corporations still hold 54.8 per cent of all shares on the Tokyo Stock Exchange. Commentators argue that these investors still prioritise business relationship reciprocity over the maximisation of shareholder value (Milhaupt, 2003, p. 19). Additionally, some firms remain management-centred. In 2005, seven major Japanese companies, including the electronic giant Panasonic, decided to introduce defensive measures without submitting proposals at their shareholders' meetings (*Daily Yomiuri*, 8 January 2005). Under this structure the board alone is the sovereign decision-maker regarding poison pill implementation in the case of an unsolicited bid. Although the conduct of seven companies is far from reflective of the attitude of all of corporate Japan, it illustrates that at least some firms are still willing to ignore the views of shareholders. More recently, in the shadow of case law diverging again from US law, companies are taking shareholders' resolutions more seriously. However, as noted in Chapter 8, this too may be expecting too much from shareholders in the current Japanese context.

1.4.2 Independent directors

The independent director system, even more so, remains in its infancy in Japan. Traditionally lifetime employment and loyalty-based company promotions ensured that a company's management remained insular, with minimal intervention from outsiders (Gilson and Milhaupt, 2004). It was only after a 2002 Commercial Code amendment that a clear role for independent directors in Japanese companies was defined (*Tokubetsu Reigai Ho*, Special Exception Law, art. 21(5)). The 2002 amendment, part of the wave of corporate governance reform since the early 1990s, was aimed at increasing the international competitiveness of Japanese companies through an improved structure for corporate monitoring (Takahashi and Shimizu, 2005, p. 39). Now incorporated in the new Company Law, major companies have the option of adopting a US-style 'committee system' structure (Company Law, arts 326–8). Companies adopting the new system must establish three committees – nomination, audit and compensation – under the board of directors, with each committee comprising a majority of outside directors.

As elaborated also in Lawley's Chapter 6 in this volume, however, several factors are likely to limit the amendment's potential impact on improving corporate monitoring amongst Japanese corporations. First, the definition of an 'independent' director in the 2002 amendment seems to lend itself to a broad and quite possibly detrimental interpretation. The Company Law uses the term 'outside' director. An outside director is defined as 'a director who is not involved in the management of the company, nor is currently, or at any

time has been, an executive director, manager or employee of the firm or of any of its subsidiaries' (Company Law, art. 15). This definition is, for example, broad enough to include a director from parent companies, business partners or major shareholders. Thus, in attempting to bring openness to board management, this amendment paradoxically allows Japanese management to reinforce its traditionally closed nature.

Furthermore, the optional nature of the amendment means that Japanese companies are under no obligation to adopt the 'committee system' structure and grant independent directors a greater role in company management. Initial results show that between 2002 and 2004 only 71, or 3 per cent of eligible firms, adopted the committee system (Gilson and Milhaupt, 2004). Commentators, though, have been quick to qualify these figures and remain hopeful of increases in the coming years (Gilson and Milhaupt, 2004, p. 7).

1.4.3 Courts

The challenge for Japanese courts is significant. The Guidelines provide little instruction on when a poison pill is deemed legally reasonable. Traditionally, the Japanese judiciary, strongly influenced by the Continental legal system, has sought to apply the facts to formally enacted statutes in judging specific cases (Tsuru, 2005). The courts are now confronted with an unfamiliar task: to build a new body of law from the ground up. Commentators have been quick to remark that creating a body of law on takeover rules was no easy task for the Delaware courts, the commercial court system with the most takeover experience of any in the world. On this view, those commentators have concluded that this role may simply be beyond that of the Japanese courts, a system with virtually no experience in takeover litigation (Gilson, 2004, p. 42).

In summary, despite the positive signs for shareholders and outside directors, uncertainties still surround each institution's capacity to monitor the operation of the poison pill in Japan. Thus, on the evidence above, this chapter concludes that arguably, Japanese lawmakers are relying on an infrastructure that does not seem to have developed to the level required to ensure poison pill defences are not used by Japanese companies as a pro-management protection device.

2. THE TAKEOVERS PANEL IN AUSTRALIA

2.1 Takeover Activity and Regulation in Australia

Australia's M&A landscape is governed primarily by the Corporations Act 2001 (Cth). The relevant section is Chapter 6, which regulates the acquisition

of shares and takeovers. This is the most recent of a series of attempts by Australian lawmakers to find a suitable approach to the regulation of the M&A market. Indeed, three earlier waves of reform from 1961 suggest that Australia has struggled to find the right regulatory approach. Moreover, various groups have called recently for yet further changes, and the Takeovers Panel itself has been subjected to constitutional challenge (Armson, 2007).

Australia's first attempt at regulating the actions of corporate raiders, the Uniform Companies Act, was enacted in 1961 (Tomasic et al., 1996, p. 788). It dealt sparingly with takeovers, with only two sections directly addressing this area of market activity (Redmond, 2005, p. 887). Regulatory shortfalls (interpretative loopholes allowed unregulated stock acquisition announcements: see Austin and Ramsay, 2005, p. 1088) combined with a sharp increase of significant market activity, led to a significant review of the M&A laws in subsequent years. The significant market activity included a mining boom as well as a number of major corporate collapses in the 1960s (Tomasic et al., 2002, p. 641). The government established the Eggleston Committee in 1967 and later the Rae Committee from 1970 to 1974 to add much needed detail to M&A provisions (Tomasic et al., 1996, p. 788). Indeed, findings of the Eggleston Committee, now known as the Eggleston Principles, have been the foundation of Australia's modern M&A regulations and continue to influence current legislation.[4] The result of the various committees was the so-called *Takeover Code* in 1971 and the insertion of 25 new sections (Redmond, 2005, p. 887). Despite the major reforms in 1971, updates and changes to takeover legislation have been frequent in the last three decades.

The most recent major change arose out of the Corporate Law Economic Reform Program (CLERP), established in 1996. CLERP's objectives were to improve the efficiency of corporate regulation and reduce regulatory burdens on business (Austin and Ramsay, 2005, p. 1089). In March 2000, the resulting legislation introduced a new Chapter 6 into the Corporations Act. Chapter 6 is an attempt to strike a balance in M&A between two competing market considerations. From a competitive business environment perspective, the new regulations encourage takeovers as a means to achieve an efficient allocation of capital. At the other end of the spectrum, it supports the notions of investor confidence and market integrity through retaining the fundamental Eggleston principle of equal opportunity for all shareholders (CLERP, 1997, p. 7).

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[4] See Corporations Act 2001 (Cth) s. 602, which sets out the purpose of Chapter 6, can be directly referenced to findings taken from the Eggleston Committee. In summary, it requires that the identity of the offeror be known, there be sufficient information to assess the merits of the offer, there be reasonable time to consider the offer and a reasonable and equal opportunity be given for all shareholders to participate in the offer.

Observing takeover activity in Australia throughout this period mirrors well the narrative of regulatory fluidity depicted above. From the time of the Uniform Companies Act in 1961 until the mid-1980s, there was a progressive increase in the number of takeover bids. A takeovers boom in the late 1980s saw the number spike to a record high of almost 300 in 1988. However since then there have been year-by-year fluctuations with numbers ranging from the mid-50s to mid-90s between 1990 and 2005. In the 2004–5 financial year there were 68 takeovers. Since 1990 about 40 per cent of hostile takeovers have been successful, a rate comparable with that of the UK and significantly higher than in the US, where poison pills and other defensive measures are more widely permitted (Nottage, 2008b).

2.2 The Takeovers Panel[5]

The Takeovers Panel is the primary forum for resolving disputes about a takeover bid until the bid period has ended. Thus, during a takeover bid, the court's jurisdiction is ousted for private litigants until the bid period ends. Only the Australian Securities and Investments Commission (ASIC) or another public authority of the Commonwealth or a state can commence court proceedings in relation to a takeover bid before the end of the bid period. Standing may extend to the bidder, the target, a rival bidder or a shareholder in the context of a bid. Beyond takeover bids, the Panel has powers to declare circumstances in relation to a takeover or control of an Australian company unacceptable (Corporations Act 2001 (Cth) s. 657A(1)). The Panel may exercise these powers at any time and applications are permitted by any persons whose interests are affected by the relevant circumstances (ASIC is also permitted to make an application, Corporations Act 2001 (Cth) s. 657C(2)).

The Panel, unlike courts, is a commercially pragmatic peer review body. At present, there are 53 part-time members drawn from business, investment banking and the legal and accounting professions. This panel composition is recognition that industry participants rather than legal generalists are best placed to address the highly technical and rapidly changing nature of takeovers. When a matter is referred to the Panel by those with standing, as seen above, and the Panel decides to commence proceedings, the President

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[5] Information discussed in this section regarding the roles and procedures of the Takeovers Panel is guided by numerous commentaries on the Panel. See Redmond (2005, Ch. 12), Levy (2002, Ch. 17) Lipton and Herzberg (2006, Ch. 18), Tomasic et al. (2002, Ch. 21), Austin and Ramsay (2005, Ch. 2), and Takeovers Panel Homepage (2006), at <http://www.takeovers.gov.au/display.asp?ContentID=6http://www.takeovers.gov.au/display.asp?ContentID=560>.

of the entire Panel appoints three members to be a 'sitting Panel' (ASIC Act 2001 (Cth) s. 184). As the Panel is a national body, few restrictions apply as to where a matter may be heard. Legislation requires the Panel to conduct proceedings in a timely manner with as little formality as possible (ASIC Regulations 2001 (Cth) reg. 13).

The Takeovers Panel resulted from the CLERP Act 1999. It replaced the 1991 Corporations and Securities Panel. From the very outset, the Corporations and Securities Panel was handicapped by its own structure and procedure (Santow and Williams, 1997, p. 749). The Panel was not the main forum for disputes and, as a result, tactical litigation remained rampant in the courts. Exacerbating this, the Panel was entirely dependent on regulatory authorities for funding, administration and applications (Walsh, 2002, p. 435). The result was a virtual shunning of the Corporations and Securities Panel by takeover market participants. It was used only four times in almost ten years (Redmond, 2005, p. 891). Recognising these limitations and the Corporations and Securities Panel's stagnant existence, the CLERP Act 1999 sought to revive the almost defunct administrative body. Renamed the Takeovers Panel, initial results appear to show that the new Panel is a marked improvement on its predecessor.

At the end of 2005, five years after its introduction, the revitalised Takeovers Panel had made 148 decisions, a significantly greater number than its predecessor in half the time. Applications have been widespread, reflecting utilisation of the Panel by all market participants (Armson, 2005, pp. 669–70). Overall, bidders made the highest number of applications to the Panel (46 per cent), followed by target companies (35.1 per cent), target shareholders (10.8 per cent), other interested persons (4.7 per cent) and ASIC (3.4 per cent). Importantly, the Panel has achieved timely dispute resolution. In the five-year period it took the Panel, on average, just over two weeks (17.3 days) after the application was made to announce a decision (Armson, 2005, p. 676). As a result of these figures, the Panel has been widely praised by the Australian business community and courts. Its numerous advocates claim the Takeovers Panel has helped foster a healthier takeover market in Australia by bringing 'timeliness and commercial expertise' to the resolution process as well as encouraging key market participants like company directors and shareholders to become more active and accountable.

The rest of the section examines the Panel's roles and procedures. It does not seek to be a comprehensive review of all elements of the Panel. Rather it aims to describe the Panel's main roles and procedures to further elucidate why its advocates have been so forthright in their praise since the Takeovers Panel's inception in 2000.

2.3 Roles of the Takeovers Panel

2.3.1 Primary dispute resolution forum and unacceptable circumstances

As mentioned above, disputes in relation to a takeover, while the takeover is current, are now resolved by the Panel. Additionally the Panel's jurisdiction is further expanded through its statutory power to declare circumstances, independent of a takeover bid, unacceptable even if the circumstances themselves do not contravene the Corporations Act (Corporations Act 2001 (Cth) s. 657A(1)). There is no definition of unacceptable circumstances in the Corporations Act. Much depends on how the circumstances affect persons involved and on the market with regard to policy set out in section 602 of the Corporations Act (see Corporations Act 2001 (Cth) s. 602). In deliberating, the Panel considers any underlying policy issues before making their declaration (Corporations Act 2001 (Cth) s. 657A(2)). The Panel has a wide discretion as to what issues it may consider (Corporations Act 2001 (Cth) s. 657A(3)(b)).

If the Panel declares circumstances unacceptable, the Panel may make any orders to protect the rights or interests of persons affected and ensure the takeover bid proceeds in the way it would have had the circumstances not occurred (Corporations Act 2001 (Cth) s. 657D(2)). However, the Panel has the added flexibility courts lack to be more conciliatory through accepting undertakings from the parties (ASIC Act 2001 (Cth) s. 201A(1)). Such undertakings can be initiated by either the Panel or the parties involved (Panel Rules 2004 (Cth) r. 13.1). One way the Panel can initiate is by the distribution of draft reasons for its decisions to the parties before making a final decision (Matters Procedure Guidance Note, G.N. 21). Changes to the Panel Rules in June 2004 now actually encourage the Panel to avoid formal decisions and orders (Panel Rules 2004 (Cth) r. 12). Market participants appear also to have embraced the Panel's more conciliatory role. At the end of 2005, 38 per cent of unacceptable circumstances matters had been resolved by undertakings from at least one of the parties to the dispute (Armson, 2005, p. 678).

2.3.2 Policy creation

The Panel's other main function is that of policy creation. This is made possible through several avenues. First, the Panel can develop policy though its rule-making power that allows the Panel to clarify or supplement the provisions of Chapter 6 from the Corporations Act (Corporations Act 2001 (Cth) s. 658C(1)). This allows a 'hands on' approach for the Panel and ensures that policy implementation remains malleable and time efficient.

Indirectly, the Panel maintains an influence over policy through the publication of its decisions and the release of Guidance Notes (Walsh, 2002, p. 437). Interestingly the rule of precedent does not technically apply to Panel decisions. Despite this, it is evident that the Panel does consider prior decisions with

similar circumstances to provide a degree of consistency in decision-making and a clear regulatory framework (Armson, 2005, p. 582). The Panel also held Panel Days and consultations in its early stages (Cross, 2003, p. 379). These workshops served as an opportunity to discuss policy and current proceedings and to induct new Panel members into their role and the legislative and policy framework within which they would be working.

While these initiatives reflect inward policy development, outward development continues through the use of so-called 'post-mortems'. The Panel will conduct a post-mortem with parties to each matter once the application has been settled and usually once the takeover has finished. The Panel's aims are two-fold: to gain raw feedback on the process and importantly to build and maintain relationships with market participants. Overall the goal is the installation of confidence in the respective parties for possible future proceedings (Takeovers Panel, 2001, p. 14).

2.4 Takeovers Panel's Procedures

The Panel's rules of procedure emphasise timeliness and informality. In so doing, they remain congruent to the fast-moving takeovers market over which the Panel presides. Consequently, the Panel rules, made by the Panel itself, are brief, especially in comparison with court rules (the Panel's rule-making power comes from s. 195 of the ASIC Act 2001 (Cth)). The rules of evidence do not apply (reg. 16 of the ASIC Regulations 2001 (Cth)). However, the rules of procedural fairness do apply, to the extent that they are not inconsistent with the Panel's legislation (ASIC Act 2001 (Cth) s. 195(4)).

Once the Panel has decided to hear a matter, it issues to the parties a 'brief' detailing the matters to be examined (ASIC Regulations 2001 (Cth) reg. 22. Like the courts, the Panel can dismiss matters as frivolous or vexatious (see Corporations Act 2001 (Cth) s. 658A). The Panel will then rely mostly on written submissions from the parties, which can be made by electronic mail to avoid time delays. Generally, the Panel permits a period of between one and three days for party submissions, depending on the nature of the application. Conferences are available; however, they are used only when absolutely necessary.[6] In this situation, the Panel requires a party to obtain leave before it can be legally represented and generally leave will only be granted to those lawyers working on the transaction (ASIC Act 2001 (Cth) s. 194; Panel Rules 2004

[6] A conference will be permitted if there is a need to clarify matters arising from the application, submissions or other documents, to resolve inconsistencies or otherwise to inform the Panel. In a conference the Panel has coercive powers such as requiring a witness to attend, production of documents and provision of evidence under oath. See ASIC Regulations 2001 (Cth) reg. 35.

(Cth) rr. 11.1,11.3). In fact, leave for Senior Counsel to appear has only been granted once. This last practice is consistent with the Panel's objectives of resolving disputes quickly and cost-effectively (Panel Rules 2004 (Cth) r. 1.2).

Throughout proceedings, restrictions apply on publicity to encourage parties to provide complete information quickly and to avoid unnecessary publicity for the market or the interested parties (ASIC Act 2001 (Cth) ss 127, 186). The Panel remains accountable to the parties and the public through the giving of its reasons. Furthermore, all decisions are also subject to possible review by a Review Panel or the courts (Corporations Act 2001 (Cth) ss 657EA, 657C).

The rejuvenated Panel signifies a new approach to the resolution of takeover disputes in Australia. Excessive legalism has been replaced by a policy-driven approach focused on speedy and commercially oriented outcomes. Although the Panel is still young, analysis of its structure and procedure, as well as encouraging initial results and market feedback, suggests that in the Panel the government has found the right regulatory balance for ensuring a healthy takeovers market.

3. A TAKEOVERS PANEL IN JAPAN – A LEGAL TRANSPLANT

Against the backdrop to the Livedoor shock and the government's response through the Guidelines, corporate Japan appears ripe for implementing a mechanism such as an Australian-style takeovers panel. Given that the Japanese M&A market is in its infancy and current infrastructure may not be adequately geared to cope with likely complexities, it is an opportune juncture for the implementation of such a mechanism. The panel would be compatible with Japan's present corporate and regulatory environment, and might even facilitate the introduction of the poison pill defence into corporate Japan and more broadly attempt to positively influence the continued development of the domestic M&A market. Section 3.1 firstly considers the viability of a panel transplant from a number of perspectives: historical, legal and governance perspectives. Section 3.2 then examines how a takeovers panel based on the Australian model might function in Japan.

3.1 Is a Takeovers Panel Viable in Japan?

Historically, the transplantation of legal rules from one jurisdiction to another is a commonly observed form of legal development around the world.[7] In fact,

[7] A legal transplant can be defined as a body of law or an individual legal rule

a review of Japanese legal development over the last century reveals that Japan has been a frequent exponent of the transplant process, particularly in relation to corporate law and corporate governance regulation. Japan's original Commercial Code was imported from Germany in 1898. In the 1950s the Illinois Business Corporation Act of 1933 served as the basis for major amendments to Japanese corporate law (Kanda and Milhaupt, 2003, p. 887). The Guidelines themselves rely heavily on a takeover jurisprudence developed in the small US state of Delaware. These examples confirm that Japan has to date embraced foreign laws as a means of regulatory revision and enhancement. Importantly these examples also suggest that from a historical perspective a transplant such as a takeovers panel may be viable.

From a legal perspective, an Australian-style takeovers panel has a degree of commonality with the traditional Japanese regulatory approach for corporations. Under Japan's administrative guidance approach to market regulation, the Japanese business method is a hybrid of 'free market' and government involvement. In the context of M&A disputes, the administrative guidance system focuses on consultation between the parties and ministry officials, with an emphasis placed on informality through negotiation (MacAneney, 1991, p. 455). Also within this regulatory environment, commercial litigation is minimal in Japan, resulting in the courts normally having only a minor role in the dispute resolution process. The panel, as Section 2 demonstrates, is premised on similar methodologies for dispute resolution. Additionally, casting a public organisation such as a takeovers panel, not judicial authority, as the primary dispute forum for takeover bids is in keeping with the traditional Japanese way of implementing economic regulations.

Finally, M&A viewed normally as a disciplinary mechanism, also have the capability to be a market driven corporate governance tool (Milhaupt, 2003, p. 296). As Milhaupt and West note, takeovers have the potential to broaden the managerial outlook, expand strategic options, match governance technology with production processes and contribute to a more robust market for legal innovation (Milhaupt, 2003, p. 296). Such influence, though, requires a healthy and functioning M&A market (Milhaupt, 2003, p. 296). At present, as seen above, the M&A market in Japan is still in its infancy. This chapter suggests then that a takeovers panel, a mechanism designed to facilitate an active takeovers market, might present Japanese lawmakers with an opportunity: to harness M&A activity and gear its influence towards continued corporate governance enhancement.

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that was modelled from a law or rule already in force in another country, rather than developed by the local community. See Kanda and Milhaupt (2003).

3.2 How Would a Takeovers Panel Function?

Japanese lawmakers, through the Guidelines, are relying on an infrastructure that is not ideally placed at present to ensure poison pill defences are implemented appropriately by corporate management. This section addresses that infrastructure, area by area, to elucidate how a takeovers panel might better function. In doing so, it considers each institution's shortcomings and posits suggestions as to how the poison pill could be more smoothly implemented in corporate Japan.

Before proceeding another caveat is warranted. Legal transplants are an experiment and the outcome is usually unpredictable.[8] In this case, the unpredictability seems to be compounded. The Guidelines themselves are largely borrowed from Delaware takeover jurisprudence. The outcome of that initial transplant is still far from certain. In recognition of the possible unpredictability that surrounds the Guidelines and their implications, the following is intended only as a guide to how a panel might function in Japan.

3.2.1 Courts

The takeovers panel might act as the primary body in Japan for ensuring market participants adhere to the Guidelines' principles and resolving any disputes between participants about the legality of takeover defences. Takeovers panels are generally composed of individuals experienced in takeover matters. A small specialist body, such as a takeovers panel, is therefore inherently suited to interpreting and implementing the vague principles upon which the Guidelines are based. Since hostile takeovers are a relatively new phenomenon in Japan, such a panel could be especially beneficial for the Japanese M&A market. The advantage in introducing a panel is that, given the Australian example, this kind of body would be able to skilfully navigate the practical difficulties of M&A issues in Japan. In this role, the panel might base its approach on similar principles to those that have so far had encouraging results for its Australian counterpart, namely bringing informality, speed and a commercial focus to the resolution process. As in the Australian model, these broad-based principles might best be promoted through the panel's structure and procedure in relation to dispute resolution.

Like the Australian Panel, then, the Japanese model might have the power to make rules in relation to its procedures. This would allow the panel a 'hands-on approach' in attempting to bring informality to the resolution process. To aid initially in rule creation, a mechanism such as an objects clause

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[8] The amount of conflicting literature on legal transplants is reflective of this. For an example of conflicting views compare Watson (1993) with Kahn-Freund (1974).

might encourage panel members to take a purposive approach when interpreting the Guidelines and to consider the broader commercial consequences a rule may have on proceedings.

The Japanese takeovers panel might also have considerable flexibility regarding the dispute resolution process. Once the panel has made a finding, it might have the power to make orders to protect the rights or interests of persons affected and ensure the takeover bid proceeds in the way it would have if not for the implementation of the illegal defence measure. Additionally, a more conciliatory approach, such as undertakings, might also be available.

This chapter proposes that panel members might be encouraged initially to rely more on the conciliatory approach. This approach might create a market environment more conducive to corporate acquisitions, given Japan's current corporate situation. Japan's hostile M&A market is in its infancy and the mechanics of a poison pill defence are still largely foreign to Japanese company boards. In fact, some commentators have questioned whether takeover defences implemented by company boards in wake of the Livedoor shock in early 2005 might actually be defective and fail to properly protect companies if required (*Nihon Keizai Shimbun*, 2005). The next few years will be a trial period for the pill in Japan. In this period, a perception of encouraging compliance through conciliatory outcomes rather than punishing non-compliance through more formal orders might better serve M&A market development in Japan.

Due to the nature of takeovers disputes, a takeovers panel benefits from not only legal and regulatory but also commercial expertise in its members. Panel member recruitment can encourage a commercial focus for the panel. The Australian panel model suggests this. A panel consisting of members with a business background and significant experience in takeovers and individuals with legal and regulatory expertise, as is the case with the Australian panel, would be an advantageous model for Japan because it would provide a developing market with expert decision-makers to guide dispute resolution. The latter appears to be of particular significance when one considers that Japanese decision-makers are now required to apply the Guidelines' vague principles to the usually complex and fact-intensive matrix of takeover disputes.

As the Guidelines are still fairly new, selected members might benefit from holding panel days, as is done in Australia, to serve as an opportunity to induct members into their new roles. Critics of the Guidelines argue that they are malleable enough to accommodate strategic use by both managers and shareholders and can be given different interpretations, depending on the interests of the interpreter (Milhaupt, 2005a, p. 2211). This chapter suggests, then, that during the induction process it may be advantageous for panel members to receive instruction on policy directives underlying the Guidelines to ensure consistent application of the Guidelines' principles to takeover defence disputes.

3.2.2 Shareholders

As Section 1 notes, general shareholder awareness and shareholder activism is on the rise in Japan. Despite this trend, keeping abreast of the changing M&A market and comprehending the new Guidelines could prove difficult for lay investors. The panel's role in relation to Japanese shareholders, therefore, might largely revolve around educating shareholders about these changes. This would assist shareholders in two ways: keeping them informed of market changes and better preparing them for the specific role lawmakers envisage for them in relation to the Guidelines.

The panel might take on its educational role in several ways. At the outset, it might issue panel practice instructions as to when shareholders would have standing in a takeover defence dispute. During the dispute resolution process, the panel might also seek submissions from shareholders, if they express interest in the proceedings, as a way of involving shareholders directly in the decision process.[9] Once the panel has made a decision the publication of the decision and subsequent media publicity might also serve as useful educational outlets to shareholders. Additionally, after the panel has resolved a dispute, the use of the post-mortem process might be a way to directly liaise with the parties and verbalise policy directives regarding shareholders in a one-on-one setting.

3.2.3 Independent directors

The independent director system is a relatively new concept in corporate Japan and so far has been largely ignored by Japanese companies. Compounding this, the recent legislative definition of an independent director arguably lacks clarity and is potentially open to manipulation by corporations. However, a panel could provide market participants with a different perspective on independent directors, by emphasising the importance of active independent directors to the hostile M&A market. The potential benefit of this is that companies would be better informed about independent director systems when implementing the takeover defences.

The panel might release guidance notes which set out a clear explanation of the role it expects independent directors to fulfil under the Guidelines when a company adopts takeover defences. In particular, the guidance notes might set about outlining what constitutes an 'independent evaluation' of a takeover defence measure by independent directors as required in the Guidelines.

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[9] This suggestion was mooted in Australia in *Re Pasminco Ltd* (2002) 41 Australian Corporations and Securities Reports 511. However currently it is not available to Australian shareholders. The Panel decided not to take such steps because it considered directors could represent shareholder interests and also because of the administrative difficulty in receiving potentially thousands of responses.

Alternatively, a more direct approach might involve inviting independent directors to any panel days held. These workshops might serve then as an opportunity not only for the panel members to familiarise themselves with legislative and policy framework but also for independent directors to do the same. This chapter envisages that this might bring to independent directors a greater awareness of the responsibilities they hold in the poison pill implementation process.

Again, as suggested above with shareholders, the publication of panel decisions and the use of post-mortem sessions might be useful in continuing the education process. Importantly these mechanisms are a way of ensuring that independent directors become aware of any changes in what the panel expects their role to be when a company implements takeover defences.

4. CONCLUSIONS

The Livedoor shock has awoken the hostile M&A market and subsequently placed Japan Inc. at an important developmental juncture. Horie's bold and pugnacious business strategy along with the recent surge in hostile M&A activity, has created an atmosphere of uncertainty and anxiety amongst market participants, particularly in the company boardrooms across Japan. Corporate Japan, however, has responded decisively. Following Livedoor, many companies have implemented management-preserving takeover defence measures, including the US-style poison pill.

Through the Guidelines, the Japanese government implicitly endorsed corporate Japan's reaction. The Guidelines rely on an infrastructure – shareholders, independent directors and courts – to police the implementation of the poison pill defence measures. However, lawmakers are depending on institutions that despite some indicators to the contrary, particularly in relation to shareholders, are at present incapable of adequately policing the poison pill's introduction into the Japanese corporate environment. Potentially this undermines the implementation process and the effectiveness of the poison pill defence.

What the Australian example offers is a model that may facilitate the implementation process. Close examination of the Australian Takeovers Panel reveals a panel model that, according to current statistics and industry participants, is finding success. Admittedly this success is in a takeovers market that is different from the Japanese market. However, the reason this model is a viable option for transplantation to Japan is that the Australian-style panel can provide the Japanese market with an expert body geared specifically towards takeovers and resolution of takeover disputes. An examination of the Australian Takeovers Panel supports this proposition.

The Takeovers Panel is the main dispute resolution body for resolving takeover disputes. In taking on this role the Panel endeavours to be speedy and commercially focused. These aims are reflected in the Panel's structure and procedure. Key indicators include the commercially oriented panel make-up, flexible approach to dispute resolution, brevity of rules and policy creation powers. So far results are encouraging. Statistical evidence and market feedback suggest the Panel is functioning pursuant to its policy goals and is contributing to a healthier takeover market in Australia.

This chapter has kept all comments and suggestions on how a takeovers panel might function in Japan at an overview level. This is in recognition of the fact that the outcome of this experiment in foreign law transplantation is uncertain, as all legal transplants are. Ultimately, a takeovers panel in Japan, if considered as a reform model for Japanese corporate law, may bear only passing resemblance to the Australian model on which it might be based. Regardless of the further changes that may occur in Japan's M&A market and the precise path of future corporate regulatory change, it is hoped this chapter can be regarded as a possible alternative point of view for corporate regulation in Japan and might offer a point of departure for any reconsideration of the status quo.

Finally, let me end with this postscript: Takafumi Horie was sentenced to two years and six months' jail on 16 March 2007, having been found guilty of financial fraud and securities law violations in relation to Livedoor activities. The lasting impact that Horie's case will have on corporate Japan is still unknown. Is Horie's case an anomaly or a sign of the future for corporate Japan? Time will be the judge. Perhaps Livedoor's immediate impact will be more significant by providing the opportunity to reconsider the state of play in the Japanese M&A market.

8. Corporate governance at the coalface: comparing Japan's complex case law on hostile takeovers and defensive measures

Mitsuhiro Kamiya and Tokutaka Ito

1. INTRODUCTION

In Japan, corporate governance issues were not discussed seriously until quite recently. This was primarily due to the so-called 'main bank' system (introduced in this volume's Chapter 4 by Puchniak) and Japanese-style cross-shareholding (*kabushiki mochiai*), which predominated during the era of high-speed economic growth achieved in post-war Japan. Main banks, highly regulated and influenced by the Ministry of Finance (MoF) under the infamous 'convoy system' (*goso sendan hoshiki*, whereby banks moved at the speed of the slowest), effectively directed the management of the Japanese companies.[1] Cross-shareholding among business partners, including banks, reflected and promoted strong solidarity in the Japanese business world. These two factors, along with the lifelong employment system (introduced in Wolff's Chapter 3), significantly contributed to Japan's unprecedented economic growth. Understandably, as long as such economic growth continued, the non-existence of truly effective corporate governance and the 'dark' side of the main bank system and cross-shareholding were not of major concern. As long as Japanese companies were protected by their main banks and stable shareholders, the management of such companies did not have to face corporate governance issues. One exception was when they were illegally 'threatened' by corporate racketeers *(sokaiya*: Milhaupt and West, 2000). Yet even this issue tended to be treated as an issue of compliance (abiding by the law) rather than broader governance (how to manage companies efficiently and legitimately for stakeholders).

[1] This chapter focuses on publicly traded companies, unless otherwise stated.

These 'glory days' for management ended with the burst of the 'bubble economy' in the early 1990s. Banks could no longer control the companies for which they acted as main bank because they were confronted with their own financial crises and had to eliminate tremendous amounts of non-performing loans. Many companies also faced similar financial crises and were forced to sell other cross-held shares, not only to procure their working capital but also to secure their financial soundness. They were seriously threatened by a significant decline in stock prices in the sagging stock market following the burst of the bubble economy. This issue became more urgent after the introduction of the current value accounting method for share evaluation (from 2000, as outlined in Table 1.1 in this book's introductory chapter). Further, declines in stock prices and the weak yen enabled foreign institutional shareholders, as well as recently developed private equity or hedge funds, to acquire a significant amount of stock in Japanese companies. However, with the gradual recovery of the Japanese stock market, many companies are now starting to utilise the capital markets much more than before. This means changing their primary financing method from indirect to direct financing (as suggested, for Japan's largest companies, in the data analysed in Kozuka's concluding Chapter 10).

These various factors have caused significant changes in the shareholder composition of many companies. Such companies are now obliged to be more conscious of their shareholders and the market, which is inevitably accompanied by companies' awareness of who are or will be their 'new' shareholders. Thus, companies have now started to take corporate governance more seriously.

A recent development is that corporate governance is often discussed in relation to companies' attitudes towards hostile takeovers. The number of M&A transactions, in particular the number of hostile M&A transactions, has increased dramatically. This is occurring in the broader context of FDI liberalisation (as outlined in Pokarier's Chapter 9 in this volume). As a result, a significant number of Japanese public companies have introduced defensive measures, most often involving the so-called 'advance warning system' (*jizen keikoku gata*, detailed in Section 5 below). This is quite unique, and certainly different from the defensive measures that have evolved in the US. This chapter therefore discusses corporate governance in Japan by focusing on hostile takeovers in the following ways:

- why some Japanese public companies have taken such directions;
- whether that has any relation to the governance structure of Japanese public companies; and
- in any event, whether it is a correct direction particularly from the standpoint of the US, the country with the most experience with poison pills and other defensive measures.

We have been very fortunate to have been involved in recent major hostile M&A deals in Japan, such as SMBC/UFJ Bank, Livedoor/Nippon Broadcasting System (Milhaupt, 2005a; and Dooley's Chapter 7, in this volume), Oji Paper/Hokuetsu Paper, and most recently Rakuten/TBS (see generally Puchniak, 2008). With this experience in mind, we present a preliminary analysis of this issue by examining the distinctive Japanese case law on the validity of defensive measures (see also, for example, Kozuka, 2006; and Osugi, 2007). We compare key Delaware case law on the same issue because the Delaware courts have dealt with the issue for about fifty years, and their decisions have been frequently referred to in recent Japanese discussions about defensive measures.

2. JAPANESE CORPORATE GOVERNANCE UNDER THE COMPANY LAW REFORMS

After patchwork efforts to improve the corporate governance of Japanese companies over the last few decades, the Japanese legislature finally decided to conduct an overall reform of the Japanese company regulatory regime. On 26 July 2005 it enacted the Company Law (No. 86 of 2005: the *Kaishaho*), which became effective on 1 May 2006.[2]

In terms of corporate governance, the Company Law drew a very clear line between a 'public' company (*kokai kaisha*) (which is defined by the Company Law to mean a company that does not have a stock transfer restriction in its Articles of Incorporation) and a 'private' company. While a private company has much more flexibility as to how to structure its corporate governance, a public company has very limited flexibility. First of all, a public company must have a board of directors, consisting of at least three directors (Company Law, arts 327(1) and 331(4)). Secondly, a public company whose stated capital is 500 million yen or more, or whose total liabilities are 20 billion yen or more, must have either (a) three committees (*iinkai*, namely a Nomination Committee, a Compensation Committee and an Audit Committee) and at least one Executive Officer (*shikko-yaku*), or (b) a board of statutory auditors (*kansayaku*: arts 2(12), 328(1) and 402 of the Company Law). Accordingly, most listed companies (companies whose stock is listed on any of the Japanese stock exchanges) must adopt one of these forms.

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[2] Before this overall reform, there were some study groups set up by certain governmental agencies relating to corporate governance. These included the Study Group on Management of Company and Financial Reporting (*Kigyo keiei to Zaimu Hokoku ni Kansuru Kenkyukai*) and the Study Group on Disclosure and Evaluation of Corporate Activities (*Kigyo Kodo no Kaiji to Hyoka ni Kansuru Kenkyukai*), both established by the Ministry of Economy, Trade and Industry (METI).

Up to now, a relatively small number of listed companies have opted for the three committees, although these included certain leading companies such as Sony, Nomura, Hitachi, Toshiba and Orix (elaborated in Lawley's Chapter 6 in this volume). The most important characteristic of this system is that a majority of the members of each committee must be 'outside directors' (*shagai torishimariyaku*) (Company Law, art. 400(3)).[3] When this system was originally introduced by way of amendments to the old Commercial Code in 2003, it was said that the committee system would be a better corporate governance structure. Also, as discussed below, the existence of outside directors could be helpful if the same argument as in Delaware case law on the validity of defensive measures were applicable to the adoption of defensive measures by Japanese listed companies. Why, then, have only a relatively small number opted for this system? Does it relate to the prevailing view that in Japan it is very difficult to find independent directors?

3. DELAWARE CASE LAW ON THE VALIDITY OF DEFENSIVE MEASURES

The Japanese case law on the validity of defensive measures only started to develop a few years ago, although some principles grew out of a smaller run of takeovers in the late 1980s (Kozuka, 2006). By contrast, the Delaware case law on the same issue emerged as early as the 1960s. Hence, we first introduce very briefly the current status of the Delaware case law on the validity of defensive measures, before moving to an overview of the Japanese case law.

Before *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), in order to determine the validity of defensive measures adopted by a company to defeat a hostile acquirer, the Delaware courts applied either of two traditional tests: (a) the business judgment rule, and (b) the entire fairness standard. The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. It exists to protect and promote the full and free exchange of the managerial power granted to Delaware directors (*Smith v. Van Gorkom*, 488 A.2d 858, Del. 1985). Accordingly, if the business judgment rule should be applied when there are no allegations of fraud, bad faith, or self-dealing, or proof thereof, then the validity of defensive measures can be relatively easily

[3] The definition of 'outside director' is, in short, a director who neither is nor was an executive director or executive officer or employee of the company or its subsidiary (Company Law art. 2(15)). This does not cover, for example, a director, and so on, of a parent company.

upheld. On the other hand, if fraud, bad faith, or self-dealing is established, then the entire fairness standard requires the target company to prove that the defensive measure being taken is fair to the target's shareholders, which may be extremely difficult.

However, the two traditional tests were problematic in that there was a tendency to oversimplify the situation to reach black-and-white conclusions. In fact, the target management's decision to adopt defensive measures normally raises business considerations, while creating the risk of possible conflicts of interest. As a result, the Delaware courts created the so-called '*Unocal* test': (a) directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership, and (b) directors must also show that the defensive measure is 'reasonable in relation to the threat posed'. Under (a), directors must satisfy that burden 'by showing good faith and reasonable investigation' and 'such proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards'. Accordingly, the *Unocal* test also recognises the importance of outside independent directors' involvement[4,5] in the target management's decision to adopt a defensive measure.

On the other hand, the *Unocal* test should not be used where the company is put up for sale (*Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173, Del. 1986). This is because, in such a case, the target's directors no longer face threats to corporate policy and effectiveness, or to the stockholder's interests, and the directors' role changes from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company (the so-called '*Revlon* duties'). Importantly, therefore, if the target management decides to sell its company to a preferred purchaser, it should not adopt a defensive measure to defeat another unsolicited purchaser. In fact, *Paramount Communications, Inc. v.*

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[4] Note that the definition of 'outside independent director' is much narrower in the US than that of 'outside director' under the Company Law, as described above. For instance, the New York Stock Exchange requires a higher standard of independence – 303A.02 (Independence Tests) of the NYSE's Listed Company Manual states (a) 'No director qualifies as independent unless the board of directors affirmatively determines that the director has not material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the listed company).' Companies must identify which directors are independent and disclose the basis for that determination. In fact, 303A.02(b) gives more concrete criteria to determine whether a director is independent.

[5] The Delaware court has basically applied the *Unocal* test to the management's adoption of a defensive measure such as a poison pill *before* the takeover battle starts. See, for example, *Moran v. Household International Inc.*, 500 A.2d 1346 (Del. 1985).

Time Incorporated, 571 A.2d 1140 (Del. 1990) confirmed that the *Revlon* duties may be implicated not only when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganisation involving a clear breakup of the company; they also arise where, in response to a bidder's offer, a target abandons its long-term strategy and seeks alternative transaction also involving a breakup of the company.

Space precludes a review of subsequent Delaware court decisions, which have refined the *Unocal* test and the *Revlon* duties. What we wish to emphasise is that in the US, compared for example with the English law tradition (Armour and Skeel, 2007; Nottage, 2008b), target management is expected to play a more important role than the shareholders when it adopts a defensive measure regardless of whether there is a contest for control.

4. JAPANESE CASE LAW ON VALIDITY DEFENSIVE MEASURES BEFORE THE *BULLDOG* DECISION

4.1 The Primary Purpose Rule

In Japan, the first rule developed by the courts regarding hostile takeovers is the so-called 'primary purpose' (*shuyo mokuteki*) rule. This was created by the Tokyo District Court's landmark decisions in *Shuwa v. Chujitsuya* and *Shuwa v. Inageya* (2 July 1989, 1317 Hanrei Jiho, p. 28). The Court invalidated the proposed issue by Chujitsuya and Inageya of a significant number of new shares by way of third-party allotment to each other, which would have resulted in a significant dilution of Shuwa's shareholding in these companies. The Court concluded that the primary purpose for the issue of such new shares was to dilute the shareholding of a specific shareholder (that is, Shuwa) and to maintain control by the incumbent management.

It is true that this 'primary purpose' rule can be used effectively where an unsolicited party seeks control of the company, as it is a relatively clear rule to apply. The court only needs to examine whether the company has cash needs to be funded by the issue of new shares; and, if so, whether such cash needs are the primary purpose of the issue of new shares. However, the primary purpose rule has two fundamental problems. First, there is too much emphasis on the company's cash needs, as it is not always easy to look into the target's subjective intent in issuing new shares. Secondly, it cannot be applied to the issue of warrants as this involves no immediate cash need.

4.2 The *Livedoor/NBS* Decision

Since the primary purpose rule has fundamental problems, the court had to

take a slightly different approach when Livedoor challenged the proposed issue of warrants by Nippon Broadcasting System (NBS) to the Fuji Television Network (Fuji TV). The Tokyo District Court (11 March 2005, 1173 Hanrei Taimuzu, p. 143) first rephrased the primary purpose rule in connection with the unfair issue of warrants. It held that the issue of warrants should not be permitted if their issuance would be 'significantly unfair' (*fukosei hakko*), that is, if the warrants are issued as a means to achieve unfair purposes. The Court struck down the issue of warrants by NBS to Fuji TV, aimed at defeating Livedoor's attempt to acquire control over NBS. The Court ruled that, in a contest for control over a corporation, it should not be permitted to issue warrants to a third party for the primary purpose of preserving the management's control of the corporation unless there are special circumstances that justify the issue from the viewpoint of protecting the interests of the corporation or those of its shareholders. The Court derived this conclusion from a theory about the allocation of authority between the shareholders and the board. Specifically, the board's authority comes from the shareholders (in other words, the shareholders choose their board), so the board should not prevent changes in the shareholders during the contest for control.

Although NBS appealed this decision, the Tokyo High Court (23 March 2005, 1899 Hanrei Jiho, p. 56) basically affirmed it, clarifying what constituted special circumstances that may justify the issue from the viewpoint of protecting the shareholders' interests. The High Court stated that such special circumstances exist where: (1) the hostile bidder does not intend to promote in good faith a rational management of the target company; and (2) the acquisition of control of the target company by the hostile bidder would cause irreparable damage to the company.[6]

[6] The decision further elaborated what constitutes special circumstances. The High Court gave the following four examples: (1) the bidder is a so-called 'greenmailer'; (2) the bidder is acquiring the target company's shares in order to gain temporary control of the target and transfer to itself or its group companies the target's intellectual property rights, know-how and other proprietary information, and major business partners and customers; (3) the bidder is acquiring the target company's shares in order to gain control of the target company and divert assets of the target company to repayment of obligations of the bidder or its group companies or to pledge such assets as collateral for such obligations; or (4) the bidder is acquiring the target company's shares in order to gain temporary control of the target company, dispose of valuable assets of the target company that are not related to the target company's current business operations (for example, real estate, securities), and to distribute a considerable ad hoc dividend – using the proceeds from such disposition, or to sell the acquired shares at a suddenly increased stock price triggered by such a high dividend.

4.3 The *Nireco* and *Yumeshin/JEC* Decisions: Pre-bid Measures

The *Livedoor/NBS* decisions revealed judicial reactions to defensive measures (i) using warrants, not new shares, and (ii) adopted *after* the takeover battle actually started. In the *Nireco* case, the Tokyo District Court (1 June 2005, 1218 Kinyu Hanrei Jiho, p. 8) considered the validity of a defensive measure (i) using warrants, but (ii) taken *before* the takeover battle starts.

The Court took a very different position from that in *Unocal*. It held that the management should not be permitted to issue warrants that can become exercisable after the contest for control arises because, if there is no contest for control, a defensive measure should be introduced by the management with the shareholders' approval. If there is no contest for control but the management still wishes to issue warrants as a defensive measure, the Court required the management to prove that:

1. the warrants should be redeemable upon shareholders' approval;
2. the warrants can become exercisable only if:
   a. the hostile bidder does not intend to promote in good faith the rational management of the target company;
   b. the acquisition of control of the target company by the hostile bidder would cause irreparable damage to the company (provided that the determination of whether such special circumstances exist is made objectively, not arbitrarily by the board);
3. the warrants should not cause any unexpected harm to shareholders other than the hostile bidder.

The Court concluded that Nireco's issue of warrants as a defensive measure could not be sustained because it did not satisfy these conditions.[7]

On the other hand, the Tokyo District Court was willing to allow the target management to buy time if an unsolicited bidder showed up. In the case of *Yumeshin Holding v. Japan Engineering Consultants* (*JEC*, 29 July 2005, 1742 Shoji Homu, p. 42), the Court upheld JEC's implementation of stock splits as a defensive measure to defeat unsolicited offers by Yumeshin as this only had the effect of delaying Yumeshin's offer. The Court did state that the target's management may require the acquirer to provide its proposal of the business plan after the acquisition is achieved so that the target's shareholders can consider it, and also may take certain action appropriate to protect the shareholders' interests if the acquirer fails to provide such proposal.

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[7] The Tokyo High Court (15 June 2005, 1219 Kinyu Hanrei Jiho, p. 8) upheld the Tokyo District Court's decision because Nireco's issue of warrants would probably cause unacceptable harm to the existing shareholders.

4.4 Japanese Courts' Basic Position on Valid Defensive Measures

The important logic behind these rulings is clear. The management's authority to manage the company comes from the shareholders through their appointment. Thus, the management's ability to interfere with any change in the shareholders should be limited, and the management's adoption of a defensive measure should be authorised by the shareholders where there is no contest for control. The management, however, can demand an unsolicited acquirer to provide certain information so that the target's shareholders can decide whether to accept the offer, and can only take certain actions appropriate to achieving that purpose. We suspect that these rulings are affected by the courts' lack of trust in management, particularly due to the lack of truly independent directors in Japanese companies. If shareholders cannot rely on independent directors to cause the management to make a legitimate decision on adopting a defensive measure, it may be better for the shareholders themselves to decide. This is because the management's adoption of a defensive measure always involves potential conflicts of interest.

On its face, this makes sense. However, considering that the shareholders' meeting is not an organ appropriate to make such important decisions in a timely fashion, and that the management can easily manipulate the direction taken by the shareholders' meeting, placing too much focus on the shareholders' powers seems to be very dangerous. Are the Japanese courts going in the right direction? In any event, their lack of trust in independent directors may have some negative impact on listed companies' willingness to adopt the committee-based corporate form, which requires a majority of directors to be at least 'outside' directors (Puchniak, 2003; and Lawley, Chapter 6 in this volume).

5. THE CORPORATE VALUE STUDY GROUP'S POSITION ON VALID DEFENSIVE MEASURES

Amidst growing attention to hostile takeovers through the various cases outlined above, in May 2005 the Corporate Value Study Group[8] released a report entitled 'Corporate Value Report – Proposal toward establishment of rules for a fair business community' (the 'Report'). After discussing the importance of the establishment of fair rules governing takeover transactions, and

[8] The Corporate Value Study Group was organised by METI and headed by Professor Hideki Kanda (University of Tokyo). See further Dooley's Chapter 7 in this volume.

reviewing the historical process of the development of such rules in the US and Europe, the Report concluded as follows:

A. The same level of takeover defensive measures as adopted in the US and Europe (such as shareholders' rights plans and 'golden shares') could be introduced in Japan under the Company Law, if disclosure rules regarding takeover defensive measures are also established.
B. The validity of takeover defensive measures should be determined by looking into the 'Corporate Value Standard', that is, by considering whether:

    1. such measure could negatively affect the corporate value;
    2. such measure is excessive;
    3. management of the target made the decision to introduce such measure in a reasonable and fair way.

C. In order to eliminate excessive defensive measures and make such measures reasonable from the perspective of corporate value improvements:
    1. defensive measures should be adopted in 'peacetime' (that is, before any specific takeover activity is commenced), with contents thereof properly disclosed and accounted for;
    2. defensive measures should be designed so they can be cancelled by resolution of a general meeting of shareholders (as a result of a proxy fight, potentially);
    3. at least one of the following mechanisms should be adopted so as not to prevent any decision being made for 'self-protection' of the board of directors:

        - mechanisms to emphasise the decision of independent personnel, including outside directors or statutory auditors, with respect to the maintenance or cancellation of defensive measures;
        - mechanisms to establish beforehand the objective conditions needed to cancel defensive measures (for example, conditions as to negotiation period and decision-maker), and to make the board delegate the decision to shareholders by way of TOB and limit resistance against takeovers likely to increase corporate value;
        - mechanisms to obtain from shareholders, by resolution of a general meeting of shareholders in peacetime, (i) approval as to adoption of defensive measures, and (ii) authorisation to decide

on cancellation of such measures when any takeover is commenced (for example, procedures and standards for decision making by the board).

The Report recommended that the Japanese government establish Guidelines regarding takeover defensive measures in order to develop the infrastructure needed in the corporate environment, including shareholder primacy and the adoption of independent directors.

While the Study Group made valuable efforts to elaborate rules and reach appropriate or practical answers, given Japan's current legal system and corporate culture, the concept of 'corporate value' is not very clear. This makes it difficult for practitioners to rely on the Group's 'Corporate Value Standards'. After the Report was published, however, a significant number of listed companies adopted a Japanese-style but relatively weak defensive measure – the so-called 'advance warning system' (AWS). Currently as many as 439 companies have introduced this system.[9] Generally, under the AWS the target's management gives an 'advance warning' to a possible acquirer by setting the rules under which it will issue 'poison pill' warrants if the acquirer acquires the target's shares in excess of a certain threshold (normally 20 per cent) without first discussing the proposed bid with the target's management. It effectively requires a shareholder who wishes to increase a shareholding beyond the prescribed threshold to notify the company of its plans as to how to manage the target after the acquisition. If the director determines (upon the recommendation of a special committee consisting of independent directors, statutory auditors and/or external advisors) that the shareholder's 20 per cent or more shareholding may damage the Corporate Value, then the director is permitted to issue new shares or warrants or to take any other defensive measures.

One of the problems of the AWS is the independence or accountability of the special committee, which plays an important role when the management decides to adopt actual, more effective defensive measures, such as the issue of 'poison pill' warrants. If the members are outside directors or statutory auditors, their independence may be problematic. If the members are external advisors such as lawyers, their accountability may also be problematic.

Another problem with the AWS is who should authorise its adoption. It has generally been considered that the AWS can be introduced by the management so long as it contains a 'sunset' clause under which a shareholders' resolution can cancel it. However, in light of the Tokyo High Court's comments in the

[9] As of the end of March 2008. Statistics reproduced here are drawn from 'Defensive Measure – Statistics & Data' (MARR, May 2008).

Livedoor/NBS case regarding the theory of allocation of authorities between the shareholders and the board (Section 4.2 above), one important issue became whether shareholders' approval of a potentially significant dilution of shareholding as a defensive measure is necessary at the time that defensive measure is introduced and/or exercised. Reflecting such concerns by the companies, a vast majority of companies (387) have obtained shareholders' approval.

6. THE *STEEL PARTNERS* OR *BULLDOG SAUCE* DECISIONS

The case of *Steel Partners ('Steel') v. Bulldog Sauce ('Bulldog')* was decided while such discussions were proceeding. It attracted significant attention from legal academics and practitioners,[10] because it was the first case where a defensive measure was exercised with the shareholders' approval. This case was also highly publicised because it was ultimately reviewed and decided by the Supreme Court, which is still fairly exceptional in takeover disputes.

6.1 Facts

In the *Bulldog* case, Steel suddenly launched a TOB on 18 May 2007, offering a TOB price of 1584 yen per share to acquire 100 per cent of Bulldog shares. After Bulldog and Steel exchanged questions and comments in writing in accordance with the recently amended TOB rules,[11] Bulldog decided to implement a defensive measure – to allocate stock acquisition rights warrants with unequal conditions to shareholders (differentiating Steel from other shareholders). Bulldog also sought endorsement by shareholders at their annual meeting. At the meeting held on 24 June 2007, the allotment of stock acquisition rights was approved by affirmative vote of as much as 88.7 per cent of voting shares held by shareholders present at the meeting (and representing 83.4 per cent of total voting rights). The primary terms and conditions of such stock acquisition rights were as follows:

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[10] In Japan, see for example *Bessatsu Shoji Homu* No. 311, 2007; and Tanaka (2007a, 2007b). In English, see already for example Yanaga (2008) and the newspaper articles cited in Chapter 9.

[11] The amendments to what is now the FIEL, effective from 13 December 2006 (see Table 1.1 in the introductory chapter), enable the target company to pose questions to bidders and to require their responses. The aim is to provide shareholders with information sufficient to decide whether or not to tender their shares into the TOB.

Number of stock acquisition rights to be allocated	Three times the number of outstanding shares as of the cut-off date, with each acquisition right entitling the holder to receive one share
Cut-off date	10 July 2007
Effective date	11 July 2007
Exercise price	1 yen
Exercise period	From 1 September 2007 to 30 September 2007
Condition of exercise	Steel and its related parties ('Unqualified Parties') may not exercise stock acquisition rights
Transfer restriction	Approval by the Board is required
Call provision	Bulldog may compulsorily repurchase the stock acquisition rights subject to a call option held by Unqualified Parties at 396 yen per unit (this price calculated on the basis of the TOB price of 1584 yen; later changed to 1700 yen, but Bulldog did not change the repurchase price)

Steel sought preliminary injunctive relief against the allotment of such stock acquisition rights. Ultimately, three courts reviewed and decided the case from the viewpoints of whether such allocation (i) conflicts with the principle of equal treatment of shareholders (*kabunushi byodo no gensoku*), and (ii) constitutes materially unfair issuance (*ichijirushiku fukosei na hakko*).

6.2 The Tokyo District Court Decision

First, the Tokyo District Court (2 July 2007, 1805 Shoji Homu, p. 43) held that the allotment did not contravene the principle of equal treatment of shareholders because (i) it was approved by the super-majority resolution of the shareholders' meeting and (ii) financial equality among the shareholders was to be secured by providing the Unqualified Parties with appropriate consideration corresponding to the number of shares held by such Unqualified Parties. In this regard, the Court determined that financial equality among the shareholders was secured because the amount of consideration to be provided was determined to include such a premium as originally proposed by Steel, in addition to the average closing price for a certain period before the commencement of the TOB launched by Steel.

In addition, the Court held that the allotment did not constitute materially unfair issuance because (i) the resolution of the shareholders' meeting did not lack manifest rationality and (ii) such allotment made as a defensive measure was appropriate. With respect to (i), the Court concluded that the resolution of the shareholders' meeting did not lack manifest rationality, for two reasons. First, Steel did not provide any future management policy despite indicating

its intent to take control of management through acquisition of all of the issued shares, nor did it provide any plan for how to exit from its investment even though it would be required to exit from its investment in order to return the capital to investors in light of its nature as an investment fund. Secondly, the super-majority resolution was not influenced by certain large shareholders other than Steel in light of Bulldog's shareholder composition. With regard to (ii), the Court determined that, for it to consider the defensive measure in question appropriate, it would be necessary to comprehensively or holistically take into consideration each of the following facts: (a) the background to the exercise of the defensive measure approved by the shareholders' meeting, (b) the existence and the extent of detriment suffered by existing shareholders due to the defensive measure, and (c) the blocking effect of the defensive measure on the acquisition. The Court concluded that the defensive measure adopted by Bulldog was appropriate because, in sum, (i) Steel did not make any proposal regarding management policy or management membership, nor did it seek with Bulldog a discussion about management policy; (ii) Steel did not respond to questions by Bulldog regarding future management policy or investment policy; and (iii) Steel did not provide enough information and time for shareholders to decide whether to sell their shares to Steel. As a result, the Court concluded that the allotment did not constitute materially unfair issuance.

6.3 The Tokyo High Court Decision

As the Tokyo District Court did not suspend the allotment of stock acquisition rights, Steel appealed. Taking a different approach to that of the first-instance Judges, the Tokyo High Court (9 July 2007, 1806 Shoji Homu, p. 40) ruled that: (i) to discriminate in treatment of shareholders did not contravene the principle of equal treatment of shareholders so long as it was reasonable in light of necessity and appropriateness to do so in order to avoid detrimental damage to the firm's corporate value; and (ii) allotment of stock acquisition rights did not constitute materially unfair issuance so long as the allotment as a defensive measure was necessary and appropriate due to a fear that an 'abusive acquirer' (*ranyoteki baishusha*) would abusively manage or control the company solely for its own benefit by taking advantage of its position as a majority shareholder. Under this framework, consideration by the High Court of both issues overlapped, because the Court examined facts supporting both necessity and appropriateness as relevant to both issues.

With regard to the necessity for Bulldog to allot the stock acquisition rights as a defensive measure, the High Court concluded that Bulldog needed to take such a measure because Steel was regarded as an abusive acquirer. So it was reasonable for Bulldog to defend itself to preserve corporate value and the shareholders' interests as a whole. With regard to appropriateness, the Court

held that, in order for it to consider the defensive measure in question appropriate, it would be necessary to comprehensively take into consideration each of the following facts: (a) the background and procedure adopted regarding introduction of the defensive measure, (b) the degree of disadvantage suffered by the abusive acquirer and other shareholders, (c) the effect of the defensive measure on the acquisition, and (d) the degree of unjustness of the acquisition method. The Court concluded that the allotment as a defensive measure was appropriate in this case because: (a) the TOB initiated by Steel was unjust and the defensive measure was inevitable, (b) the defensive measure had been introduced with the super-majority resolution of a shareholders' meeting, (c) the defensive measure would not cause excessive financial damages to Steel, and (d) shareholders other than Steel appeared to have accepted the defensive measure as appropriate.

The Tokyo High Court thus concluded that such allotment of the stock acquisition rights as a defensive measure was necessary and appropriate. Further, in substance, the framework applied by the Court was similar to that of the Tokyo District Court. However, there was a significant difference between the two rulings. They were similar in that both Courts examined necessity and appropriateness in determining whether the allotment of stock acquisition rights constituted materially unfair issuance. However, they differed in that the Tokyo High Court considered the existence of the resolution of the shareholders' meeting only as one of the facts supporting appropriateness, and not in relation to the allotment's necessity. This indicates that the Tokyo High Court did not place as much importance on the resolution of the shareholders' meeting. Indeed, this is the most important difference compared with the decisions of both the Tokyo District Court and, as discussed next, the Supreme Court.

6.4 The Supreme Court Decision

The Supreme Court (27 September 2007, 1983 Hanrei Jiho, p. 56) seemed to adopt a framework similar to that of the Tokyo High Court in considering necessity and appropriateness. It held firstly that discriminating in treatment of shareholders, where it would be likely that the firm's corporate and shareholders' interests would be damaged so as to harm its corporate value (such as threatening the existence and development of the company), did not contravene the principle of equal treatment of shareholders, so long as such treatment would not conflict with the philosophy of equity (*kohei no rinen*) and thus would not lack appropriateness. Secondly, the allotment did not constitute materially unfair issuance in light of the principle of equal treatment of shareholders so long as it would be necessary and appropriate. Further, the Supreme Court noted that the allotment of stock acquisition rights as a defensive

measure did not constitute materially unfair issuance even though such a defensive measure had not been introduced or disclosed in advance, considering that such allotment was a measure to respond to an emergency situation, and that consideration corresponding to the value of relevant stock acquisition rights to be lost was supposed to be paid.

Despite these pronouncements, the Supreme Court's standpoint regarding the weight to be given to the resolution in the shareholders' meeting was completely different from that of the Tokyo High Court. With regard to the necessity of a defensive measure, the Supreme Court ruled that necessity should be decided ultimately by the shareholders themselves, to whom the company should belong. The decision by such shareholders should be respected unless there existed any significant problems, as where the proper procedure for a shareholders' meeting was not followed, or where the facts on which the decision was based did not exist or were not true. In such cases the shareholders' decision should be ignored. In this regard, the Supreme Court concluded that it was necessary for Bulldog to allot the stock acquisition rights to defeat Steel, stating that the procedure of the shareholders' meeting could not be considered improper. This was because the allotment of the stock acquisition rights was approved with the affirmative vote of 83.4 per cent of the total number of voting rights. Therefore most of the shareholders other then Steel decided that the proposed acquisition by Steel of the control of the management of Bulldog would probably reduce the corporate value of Bulldog and the interests of its shareholders as a whole. In addition, there were not any significant problems with the shareholders' decision because Steel did not disclose its management policy or any plan for how it would exit from its investment, although Steel's TOB intended to acquire all of the issued shares. Consequently, the Supreme Court paid high regard to the resolution of the shareholders' meeting in determining the necessity of the defensive measure, whereas the Tokyo High Court considered it only as one of the factors in determining appropriateness.

The Supreme Court also considered the resolution of the shareholders' meeting with regard to the appropriateness of the defensive measure. The Court stated that most shareholders other than Steel accepted the defensive measure as a necessary measure to avoid reduction in Bulldog's corporate value. After discussion at the shareholders' meeting where Steel was present and given an opportunity to express its opinion, Bulldog's shareholders determined that such reduction in Bulldog's corporate value might occur as a result of the proposed acquisition by Steel of management control over Bulldog. In addition, the Court took into account the fact that Steel would receive payment as consideration for the stock acquisition rights that were allocated to Steel but were not permitted to be exercised, the value of which was calculated on the basis of the original TOB price that Steel itself decided.

The *Bulldog* case was the first Supreme Court decision that dealt with, and pronounced the validity of, such a defensive measure. However, this judgment revealed some problems. In particular, the Supreme Court stressed the importance of (i) the resolution of the shareholders' meeting, and (ii) the fact that the consideration corresponded to the value of the stock acquisition rights held by Steel, so the defensive measure would not lead to financial loss for Steel. This followed naturally from the theory of allocation of authority between the shareholders and the board, adopted by the Tokyo High Court in the *Livedoor/NBS* case, where the resolution of the shareholders' meeting was considered one important factor supporting the validity of the defensive measure. However, that should not necessarily have authorised the company to take the defensive measure, because the company's shareholders only had to oppose the acquisition by Steel by deciding not to tender their shares to the TOB launched by Steel. In addition, there is some doubt as to whether the shareholders' meeting is an appropriate venue to decide matters such as whether the proposed acquisition by Steel would be harmful to corporate value. This is not only because the shareholders who can vote on the matter are fixed on a certain date, and therefore likely to be very different from those present when the defensive measure is actually decided and implemented. Another reason is that management is in a better position to manipulate the vote at a shareholders' meeting. The judicial decisions, including the Supreme Court decision on the *Bulldog* case, did not explain why the shareholders' meeting can decide the issue better than the management.

Another problem is apparent from the Supreme Court decision. The Court risks supporting 'greenmailing', by considering as one of the important points the fact that the defensive measure would not cause financial loss to an acquirer. If so, acquirers will readily launch acquisitions, as the Court effectively guarantees return of capital expended by such acquirers. In short, such acquirers may get returns without any effort, while tremendous expenses are incurred for the defensive measures by the target company.[12] Such negative consequences clearly conflict with the philosophy behind defensive measures, namely to make acquirers hesitate to proceed with the acquisition under the pressure or the threat of possible significant financial loss.

Discussions regarding the validity of defensive measures developed involving not only practitioners but also the government, as can be seen from the Corporate Value Study Group. Therefore, it was expected that the Supreme Court would endorse defensive measures, upholding the validity of those

[12] Many newspapers reported that Bulldog paid more than two billion yen for repurchase from Steel of stock acquisition rights, along with legal and other advisory fees (for example, *Nihon Keizai Shimbun*, 8 August 2007). More generally, see also Pokarier's Chapter 9 in this volume.

adopted by many listed companies. In this respect, the Court revealed some of its position regarding the legality of defensive measures. However, it is questionable whether the courts have sufficiently examined whether the shareholders' meeting would be appropriate to evaluate corporate value, referred to in each of the decisions. We believe the Supreme Court's decision on the *Bulldog* case is correct in justifying defensive measures adopted by an 'honest' company, but would be applicable only to such a limited situation, as in this case itself. It is safe to assume that Japanese courts have not yet adopted a definitive stance. At any rate, the validity of defensive measures adopted only by decision of the board has not been denied even after the Supreme Court's decision in the *Bulldog* case.

Reacting more extremely to the Supreme Court's decision, however, it seems that many companies hesitant about hostile takeovers are actually entering into new types of cross-shareholding, aimed at securing favourable resolutions of shareholders' meetings. It would be unfortunate if cross-shareholding was viewed as an excuse or means to obtain justification of any defensive measure, since cross-shareholdings arguably created considerable problems in Japan's previous corporate governance system. This development seems to highlight another limit to the rationale expressed in the Supreme Court decision. Thus, we need to further consider the framework for assessing the validity of defensive measures, including new legislation to clarify this issue.

7. CONCLUSIONS

Recent Japanese case law has diverged from the Delaware case law by emphasising shareholders' involvement in target management's adoption of any defensive measure. The decision in the *Bulldog* case clearly showed this, which we view as creating serious problems for the development of defensive measures through a case law framework. Although many Japanese companies introduced US-style rights plans as a defensive measure, compared with the US, Japan lacks 'real' independent directors who can become involved in the adoption and implementation of defensive measures. In light of a current revival of cross-shareholding among listed companies, corporate governance in Japan may be deteriorating even though such companies proclaim the 'preservation and development of corporate value'.[13]

[13] Yet, ironically, many listed companies suffered significant losses from cross-held shares due to the decline in the stock market influenced by the subprime mortgage crisis in the US. *Nikkei Sangyo Shimbun* (1 April 2008) reported that out of four trillion

Japan's Pension Fund Association and large asset management companies, representing the voices of shareholders, recently strengthened their voting standards for defensive measures. In addition, the management of some companies, incuding Shiseido, Nissen and Nihon Optical, have come to recognise the disadvantages of defensive measures and have decided to abolish or not renew them. The representative director of one such company stated, 'defensive measures are actually self-protection for directors and, without defensive measures, managers are forced to do their best.'[14] It is therefore high time for Japanese companies to reconsider the kinds of defensive measures suitable for their country, and the best ways to develop corporate governance without the kinds of defensive measure available under the current regulatory framework.

yen spent by listed companies for cross-shareholding in the two years preceding September 2007, it is likely that at least one trillion yen was lost as unrealised capital losses in fiscal 2007.

[14] *Nihon Keizai Shimbun*, 21 April 2008.

9. Open to being closed? Foreign control and adaptive efficiency in Japanese corporate governance

Christopher Pokarier

How open is Japan to foreigners taking control of Japanese enterprises and what does it say about this book's theme of the 'gradual transformation' of Japan's corporate governance? Japan is formally very open to foreign direct investment (FDI), excepting certain, perhaps increasingly, 'sensitive' sectors. The Japanese Government seeks to have inbound FDI double to about 5 per cent of GDP by the end of 2010. Realisation of this objective is likely to entail more corporate control events involving foreign acquirers. While greenfield investments are occurring in some sectors, in many others FDI typically takes the form of acquisitions of existing enterprises, given the maturity of Japan's economy (ACCJ, 2003). In 2008 this disconcerts few in economies such as the United Kingdom and Australia. Yet, in the Japanese business and policy *zeitgeist* of 2008, widespread ambivalence about the foreign control of Japanese firms and infrastructure can be readily discerned. As explored elsewhere in this volume, notably in Chapters 7 and 8, recent corporate law and regulatory developments give firms considerable latitude to build protections against unwelcome control events. While provisions are not directed exclusively at foreign investors, and were indeed made topical by several contentious domestic hostile takeover bids, the explicit rationale of many of the anti-takeover defences put in place by firms has been the potential threat of a hostile foreign bid.

Yet since the late 1990s there has been a growing volume of friendly inbound merger and acquisition (M&A) activity, in addition to dramatic growth in the already much larger volume of both purely domestic and outbound M&A deals. This suggests widespread understanding of the business rationales for corporate reorganisation and the control events that can both precede and proceed from it. Much of the gradual transformation in Japan's institutional architecture of corporate governance has been demanded by its firms, albeit mediated through political, bureaucratic, and juridical processes and communities of specialist expertise. Influential Japanese corporate

constituencies want a regulatory environment that facilitates their adapting efficiently to the evolving business environment. Yet they also want the option of being free to build defences against outside bidders for control. The Japanese Government is open to firms being, with the consent of a majority of shareholders, closed to a foreign takeover, or indeed a domestic one that is seen as a threat to the rather nebulous notion of 'corporate value'.[1] The managements of Japanese firms retain significant discretion regarding bids for control and, with adequate advance planning, can put powerful defences – such as so-called poison pills – in place. Many are doing so, following the lead of Matsushita Electric, the first prominent firm to do so in April 2005 (*Daily Yomiuri*, 29 April 2005[2]). An early 2006 Nikkei survey revealed that some 70 per cent of responding executives were considering adoption of takeover defences (*Nikkei Weekly*, 27 March 2006). There are also increasing instances of firms, such as Nippon Steel, re-establishing defensive cross-shareholdings in a fashion strikingly similar to that witnessed in response to the initial liberalisation of FDI policy in the late 1960s.[3]

Mason (1992, pp. 205–7), in an illuminating historical study of the political economy of FDI in Japan up to 1980, noted that significant formal liberalisation from the mid-1960s onwards was accompanied by corresponding

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[1] See Whittaker and Hayakawa (2007, p. 20). A quote from a typical *Yomiuri* editorial is indicative of the fuzzy thinking surrounding the 'corporate value' concept: 'When a company increases profits through wage cuts, the shareholders' value will increase but its value to stakeholders, especially employees, may decrease. Therefore the corporate value does not increase in this case'. ('Companies not for shareholders alone', *Daily Yomiuri*, 24 October 2007).

[2] Throughout this chapter sources that provided simple reportage of facts are referenced, in-text, only by publication, date and wire service, if used and identified. This is due to the large number of citations and to the fact that such content increasingly appears through multiple media distribution channels. However, analyses with by-lines are cited in further detail in notes.

[3] Nippon Steel has strengthened cross-shareholdings with Sumitomo Metal Industries and Kobe Steel. It also designed its poison pill defences with a trigger being a shareholder meeting resolution deeming a bid hostile and destructive of corporate value (Mamoru Kurihara, 'Nippon Steel turns to shareholders', *Daily Yomiuri*, 31 March 2006). Notably, Nippon Steel has also moved to strengthen a defensive strategic alliance with Korea's POSCO through small cross-shareholdings (Kyodo in *Daily Yomiuri*, 21 January 2006). Then in June 2007 Nippon Steel and Sumitomo Metal Industries entered into defensive cross-shareholding arrangements with Matsushita Electric, the latter having earlier in the year put in place similar arrangements with Toyota. The shareholdings typically are less than 1 per cent, and are more broadly justified as underpinning future business collaboration, but they serve as potentially potent signalling effects of commitment to mutual defence against hostile takeover bids (Kyodo, 28 June 2007). Likewise, Daido Steel invited Toyota, Honda and Suzuki to take stable holdings in the firm as a defensive measure (Kyodo, 9 May 2007).

increases in defensive cross-shareholdings and other private barriers to FDI, in which the state was often complicit. Many contemporary financial market participants fear the same is occurring today, with strong legislative and bureaucratic support. The new Company Law (*Kaishaho*, No. 86 of 2005) promoted by the Liberal Democrat Party (LDP), which made the adoption of anti-takeover defences significantly easier, passed the Diet with the general support of the main opposition Democratic Party of Japan as well as the Social Democratic Party (Kyodo in *Daily Yomiuri*, 29 June 2005). In 2005 the Ministry of Economy, Trade and Industry (METI) and the Ministry of Justice (MoJ) gave impetus to the introduction of anti-takeover measures by firms with the release of Guidelines on precisely that, lending credence to an expansive notion of 'corporate value' (Whittaker and Hayakawa, 2007, p. 20). METI's active promotion of anti-takeover defences culminated in a spectacle in June 2007, when METI Vice-Minister Takao Kitabata convened a special press conference to stress that the increasingly common poison pill mechanism 'conforms with international standards and is legal in [our] country' (Kyodo in *Daily Yomiuri*, 15 June 2007). Kitabata was responding directly to public criticism of such defensive measures by the Chairman and CEO of controversial US investment fund Steel Partners, Warren Lichtenstein. Kitabata dismissed the US investor as having 'completely misunderstood' the situation.

Such a forthright official defence of practices likely to constrain development of a vibrant corporate control market sits uncomfortably with Japan's articulated FDI policy preferences in international forums and negotiations. At the Doha Round of multilateral WTO negotiations in Cancun, for instance, Japan had investment liberalisation as a leading priority (Tanaka, 2004, pp. 6, 27). Similar priorities have been enunciated in bilateral negotiations over Economic Partnership Agreements (EPAs), the terminology chosen by Japan to broaden the scope of bilateral deals beyond traded goods to encompass such issues as investment regimes.[4] Unlike the case of most internationally traded goods, and increasingly services, nation states are still only lightly constrained by binding international agreements in the area of foreign investment regulation. Inward foreign investment regulation is still often politically contested domestically, and only tentatively negotiated internationally. Yet the liberalising intent of the Group of Eight (G8) is formally clear, and Japan joined other G8 members in June 2007 in jointly declaring a commitment 'to minimize any national restrictions on foreign investment. Such restrictions should apply to

[4] The June 2007 agreement with Cambodia was indicative of this, as has been the initial negotiation and subsequent agreement with Singapore (Kyodo in *Daily Yomiuri*, 15 June 2007).

very limited cases which primarily concern national security' (*Daily Yomiuri*, 9 June 2007).

How is Japan's promotion of liberal FDI policy abroad to be reconciled with apparent ambivalence at home? Several explanations might be hypothesised. First, deliberate *privatisation of economic nationalism* may be occurring, as an economic nationalist government pursues FDI policy liberalisation for the nation's firms abroad while building discretely exclusionary defences at home. Second, a *discretionary public interest* explanation can be hypothesised, in which policymakers, confronted by contending ideas about the costs and benefits of foreign control, and the transition of corporate governance systems, put compromise but effectively neutral institutions in place. In this account, management, and to some degree shareholders, are being given the latitude to experiment with models of governance and degrees of openness to foreign ownership and control. A third possible explanation is essentially *discretionary private interest*, namely a pragmatic political response to contending domestic interests vis-à-vis foreign investment and control. In this account, state actors seek a political reconciliation of conflicting private interests, so empowering firms legally with means to frustrate foreign control events should it be in the immediate interests of influential constituencies of the firm to do so.

Critically, we need to assess whether the evolving public and private institutional, governance and cognitive responses to the prospect of foreign controls lead overall to a weakening of the adaptive efficiency of Japanese firms, and the economy as a whole. This chapter seeks to frame the issues analytically, but much more analysis will be needed. North (2005, p. 169) defines 'adaptive efficiency' as fundamental to sustaining the process of economic growth, 'an ongoing condition in which society continues to modify or create new institutions as problems evolve. A concomitant requirement is a polity and economy that provides for continuous trials in the face of ubiquitous uncertainty and eliminates institutional adaptations that fail to resolve new problems'. This accords with the priority given by Nottage, in Chapter 2 of this volume, to an understanding of the *processes* of change in corporate governance practices, and Puchniak's stress in Chapter 4 on precisely what allows corporate governance systems to efficiently adapt. Yet, as the influential work of North and many political economists attest to, human agency – serving either private interests or bad public interest ideas – in situations of collective choice often results in institutional and governance rigidities that are anything but conducive to adaptive efficiency.

There is valuable and growing scholarship on the recent impact of foreign investment on Japanese corporate performance, and the still open question of such investors' relationship to the gradual transformation of Japan's corporate governance. Ahmadjian (2007; Ahmadjian and Robbins, 2005), for instance,

looks at the role of foreign portfolio investors. Jacoby (2007) notes that, while such investors might be an impetus for corporate governance change, there is also evidence that firms' adoption of Anglo-American-style corporate governance practices may draw investment. Yet in early 2008 executives in leading securities firms struggle with the phenomenon of 'Japan passing': foreign institutional investors by-passing Japan for more promising destinations in the so-called BRICs (Brazil, Russia, India, China), resource-rich economies, and for revitalised firms in the other mature economies.[5]

1. A FEW FDI FACTS

In 2006, net FDI inflows into Japan turned negative for the first time since 1989 (UNCTAD, 2007, p. 69). Big disinvestments by Vodafone and GM overwhelmed the modest inflow, for which not even a notable reinvestment of foreigners' earnings in Japan to a sum of US$2.3 billion could compensate. The net 2005 figure was only US$2.8 billion, down 64 per cent from 2004 (UNCTAD, 2006). In contrast, 2006 FDI inflows into the US were worth US$175 billion, the UK US$140 billion, and Canada US$69 billion. The latter reflected the significant contribution that cross-border M&A can make, with two mining industry acquisitions each adding some US$17 billion to the inbound figure (UNCTAD, 2007, p. 67). Initial data for 2007 suggest that Japan managed to achieve net FDI inflow of US$28.8 billion, boosted principally by Citigroup's acquisition of Nikko Cordial (*Daily Yomiuri*, 10 January 2008). FDI as a percentage of GDP remains very low in Japan. In 2005 it stood at only 2.4 per cent of GDP (up from 1.1 per cent in 2000), far below the UK at 40.9 per cent, the US at 22.5 per cent and Germany at 25 per cent (US–Japan EPG, 2007; ACCJ, 2003, p. 2). UNCTAD judged that, as a consequence of the poor 2006 figures, Japan missed the target set by former Prime Minister Koizumi to double inward FDI by 2006. The US–Japan Investment Initiative 2007 Report, however, used a different calculation and declared the target met (US–Japan EPG, 2007).

Significantly, though, Japan's outbound FDI is substantial, despite the weak yen. In 2006 it reached US$50 billion, and some US$16 billion of earnings from Japanese subsidiaries abroad were reinvested there (UNCTAD, 2007, p. 70).[6] In addition to greenfield investments, Japanese firms have been increasingly active in seeking to buy foreign enterprises. For instance, in August

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[5] I am indebted to Hiroyuki Yokota, Japan equities manager for Citigroup UK, for a timely discussion of the Japan passing phenomenon, Tokyo, 17 December 2007.

[6] By region, 36 per cent went to Western Europe, 35 per cent went to Asia, and 19 per cent to North America (UNCTAD, 2007, p. 70).

2007, Fast Retailing, operator of Uniqlo, made a US$950 million offer for the US luxury department store chain Barneys New York, but was outbid by a Dubai investment house (*Daily Yomiuri*, 7 August 2007).

M&A activity in Japan has been rising notably since the turn of the century. Deals involving domestic firms alone (so-called 'in-in' deals) remain predominant. Control events involving foreign acquisitions of Japanese companies or mergers ('out-in') accounted for only about 4 per cent, both in number and value of deals announced in 2006, with the largest deal worth US$ 778 million, involving Air Liquide as acquirer.[7] By contrast, in-out deals, namely Japanese firms doing deals with firms abroad, were often much larger in value. For instance, Japan Tobacco's purchase of the UK-based Gallagher Group PLC was worth US$18.8 billion and the Toshiba-led consortium's purchase of a 77 per cent stake in the Westinghouse Electric nuclear powerhouse development business was worth US$5.4 billion. M&A data for 2007 suggest a 72 per cent rise over the previous year in the number of deals done by foreign firms to acquire, or merge with, Japanese firms – a total of 308 transactions.[8] Overall, though, the scale of cross-border acquisitions of Japanese firms is very small in relative terms.

Nonetheless, reports abound of emerging domestic M&A deals that have been driven, at least in part, by fears of a foreign takeover. Mitsubishi Pharma's merger talks with Tanabe Seiyaku is just one example (*Yomiuri Shimbun*, 19 January 2007). Interestingly, foreign investors can also play a role in putting a stop to friendly acquisitions that are thought to undervalue the target. For instance, the merger deal between Osaka Steel and Tokyo Kohtetsu was suspended following opposition from Singapore-based Ichigo Asset Management, run by Scott Callon (*Business Week*, 21 June 2007). It is hard to avoid the conclusion that the apparent rise in threat perception in relation to inbound FDI, and hostile M&A activity in particular, seems disproportionate to its actual scale. The sources of sensitivity that make the perceived threat of undesirable foreign control acts a salient public policy and managerial concern need to be understood. They may impact directly on foreign interests in Japan and provide broader insights into contemporary Japanese corporate governance.

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7 PWC HK, *Asia Pacific M&A Bulletin*, Year End 2006, p. 14.

8 Recof, reported by *Kyodo* in *Yomiuri Shimbun*, 5 January 2008. Strikingly though, the reported value of acquisitions of domestic companies was some 2.84 trillion yen in 2007, down from 3.29 trillion in the previous year (*Daily Yomiuri*, 31 December 2007, 5 January 2008). In the same period the overall number of M&A involving Japanese firms (domestically and abroad) declined slightly, for the first time in four years, as activity involving listed Japanese start-ups dropped by about a quarter. Offsetting that was a substantial rise in deals involving investment companies, to 402 cases. Takeover bids for listed firms reached 102 in 2007, well up from 65 in 2006 and 18 in 2000 (*Daily Yomiuri*, 31 December 2007).

2. ANALYTICAL APPROACH

Nationalism is political. National identity and interests are made synonymous with a national political unit and, in the eyes of patriotic citizens, entail public goods secured through collective choice. Anderson (1991) and other scholars have shown how nationalism historically often served as a political instrument for attenuating deep internal social and economic conflicts. Yet, as the analysis of both economic protectionism and the tragedy of war attest, its ultimate costs can be profound.[9] Any account of the nationalist dimensions of a corporate governance regime must rest therefore on an internally coherent theory of political economy. Recent comparative work in the politics of corporate governance by Roe (2003) and by Gourevitch and Shinn (2005) – as examined by Nottage in Chapter 2 – provides promising foundations. Neither work directly addresses, though, the political economy of economic nationalism. Roe (2003), while thoroughly schooled in the economics of law, makes the key point that corporate governance law – like any other – is delivered through political processes. Roe's (2003) account emphasises social peace as predicate for corporate success, and it might have come at a high price through firm-level and political deals that compromised managerial discretion and/or imposed costs on shareholders. This may lead to relatively stable 'packages' of (often tenuously) complementary institutions and practices, or it may lead to ongoing social instability and economic decay. Even when stability and growth are attained, it does not mean that institutional arrangements are, or will continue to be, efficient. As Lindblom (2001) and North (1981) remind us, the very prosperity of even poorly functioning market systems makes bearable the high costs of maintaining requisite social peace.

Yet, crucially, few actors are passive in the face of costly imposts designed to make others better off. The works of Roe and Gourevitch with Shinn emphasise that both market and political actions are likely to provoke defensive responses by negatively affected parties. Continental European shareholders, for instance, developed a stronger preference for block shareholding as the high agency costs of managements captured by legally protected workers became more apparent (Roe, 2003, p. 45). Likewise, Miwa and Ramseyer (M&R, 2006, p. 159) see outsourcing and overtime for limited core employees as rational responses by Japanese firms to heavy legal restrictions on layoffs, and so-called 'lifetime employment' as more a necessity than an inherent virtue for firms. In short, defensive responses to political or judicial developments may be market-based and, likewise, defences against market develop-

[9] On the opportunity costs of economic nationalism in relation to FDI see, for instance, Caves (1996) and on the huge social and economic cost of World War I see Stevenson (2004, pp. 564–8).

ments may take political form. Further, as the above examples suggest, economic and political arrangements give rise to norms and ideals that may both cloud their pragmatic origins and contribute to their perpetuation – sometimes well beyond the circumstances that brought them about.

Study of the politics of business, and indeed of the business of politics, needs a unified conception of micro-level economic and political agency under informational and cognitive constraints. The work of Roe and Gourevitch with Shinn is grounded in agency theory of the firm associated with Jensen and Meckling[10] (see, for instance, Jensen, 2000), but puts corporate governance in its political context. Political markets approaches, associated with the rational choice and public choice literatures, remind us that the leaderships of firms may make choices between devoting resources to political action, aimed at forestalling market competition through regulatory intervention, and directing those resources to product or process innovations to enhance the firm's market competitiveness. Strategic choices between *market action* and *political action* will be patterned by the expected returns to each, which is a function of both market conditions and the political environment.

2.1 Demand for FDI Policy

Elsewhere, I have sketched an analytical approach to the political market for inward FDI policy that conceptualised the structure of domestic private interests, conditions under which public interest arguments for a restrictive policy might arise, and the types of policy and administrative arrangements towards FDI that a politically calculating government would be likely to favour (Pokarier, 2004, 2007). It drew on insights from North (1981, 2005) into how interests, institutions and ideas, in complex inter-determinant ways, all have an important place in the analysis of the interfaces between politics and markets, and the process of economic change as a whole.

FDI entails much more fragmented constituencies and potentially shifting coalitions than international trade does, as interests are often transaction (control event) specific. Core constituencies are domestic competitors for markets or inputs, labour (often split between corporate insiders and outsiders), other suppliers of business inputs, domestic entrepreneurs and investors (with potentially divided interests), and domestic managements. The starting premise for an understanding of the political economy of FDI is that, in general, it will increase returns to the factors of production that it utilises in

[10] This rational-choice-based theory does not mean that people are not capable of being other-regarding, but, in the words of Jensen (2000, p. 5), 'means only that people are not perfect agents for others; in other words, people will not act in the interests of others (their principals or partners) to the exclusion of their own preferences'.

the host economy while entailing complex distributional consequences (Caves, 1996). Likewise, portfolio investment, by increasing demand relative to supply for an asset, should lead to an increase in its market value. In principle, the domestic or other owners of such factors of production and assets stand to gain, while those in competition with the foreign purchaser may bear a cost. For instance, FDI will generally increase the financial returns to labour and/or the overall employment level, and a number of studies have linked high unemployment with a subsequent shift to pro-FDI policies (for example, Kotabe, 1993; Globerman, 1988). Yet within enterprises targeted for acquisition by a foreign enterprise, there is often resistance by representatives of labour (Rugman and Verbeke, 1998, p. 126). This is often understood as reflecting fear of loss of rents following the control event as owner–management agency problems are attenuated. In part, this may be because foreign owners might be able to make more credible threats to move part of the firm's operations abroad. Insider labour support is likely to be forthcoming, though, for foreign control of a deeply distressed firm, or when unions perceive that they might be able to extract more rents from a foreign than a domestic owner (Caves, 1996, p. 123).

Domestic (potential) sellers of assets have an interest in an open investment regime because it may increase the pool of bidders, while the local buyers of assets in fixed supply would have an interest in restrictive policy. With imperfect financial markets, local bidders might pay less for an asset in the absence of foreign buyers, and this logic extends also to local equity requirements. Yet firms will often be both buyers and sellers, at least inter-temporally, and so they might favour discretionary investment policy mechanisms if they can exercise political influence over policy implementation. Suppliers of business services in general stand to gain from FDI, although there may be significant distributional impacts following a control event that leads to a rationalisation of existing supply chain arrangements. Finally, management, as a supplier of services to firms' owners, faces varied consequences of FDI depending on its form and raison d'être. Managers may stand to gain from the 'greenfield' foreign investments that present them with additional managerial career opportunities, assuming that their experience is valued and that they are competitive vis-à-vis (or protected from) expatriate managers. The consequences for incumbent managers in acquisition targets are less certain. Loss of status, if not their position, is common through the acquisition process (Hirsch, 1986, p. 800). Yet some managers who win the confidence of the new owners may gain additional (saleable) managerial experience, and sometimes a career path in an international enterprise.

Several 'public interest' arguments for restricting foreign ownership and control may arise. The first pertains to national security concerns, which have become more salient since 9/11 in the US and elsewhere. A July 2007 bill

tightened US security reviews of foreign investments in defence-related areas, and extended the process to energy-related enterprises and critical infrastructure (Associated Press, 28 July 2007). Another type of public interest argument amounts to an application of 'second best' logic. Where domestic market distortions or poorly specified property rights give rise to significant rents, permitting foreign firms to operate may result in national welfare losses. Scenarios include 'tariff-hopping FDI' and poorly managed rights to natural resource extraction (Corden, 1974, pp. 330–50). Arguments for restrictions on FDI also arise in culturally and politically sensitive sectors, such as broadcasting, and restrictions in this area in particular remain common.

Another category of 'public interest' arguments against openness to FDI is even more contentious: economic nationalism as a good in itself. Caves (1996, pp. 250–51) has provided a tentative model of citizens' preference for national economic self-determination, or a simple xenophobic preference for minimising dealings with foreigners. Voter support for control of FDI on nationalist grounds would be 'subject to the condition that real-income costs of the restriction do not outweigh the utility of the gain in perceived independence'. This raises profound questions about whether the opportunity costs of economic nationalism would be known even by policymakers, let alone voters. But it is important in giving due analytical consideration to nationalism and xenophobia in terms consistent with a rational choice approach to political economy. North's (2005) conceptualisation of pervasive cognitive constraints, even about actors' immediate economic interests under conditions of uncertainty, suggests both the resilience of (often bad) ideas as guides to action and the difficulty of knowing their opportunity costs. As Jervis (2006) explores, people often have a 'need to believe' in a particular description of the world, given their particular, and often unnegotiable, place in it.

2.2 Supply of FDI Policy

My previous work on political markets for inward FDI policy has found theoretical and empirical evidence for the hypothesis that governments' key stake in economic growth will tend to lead policy outcomes in a liberal direction, subject to certain significant qualifications. Influential domestic private-interest constituencies may present to governments an overriding political calculus in favour of restrictive measures, yet there are often equally influential countervailing constituencies for more liberal policy. Prevailing public-interest understandings about the costs and benefits of FDI have often proved decisive in governments' political calculus, as seen in the wave of largely unilateral FDI policy liberalisations across countries since the mid-1980s. Key exceptions to generally liberal policy regimes will typically be in sensitive sectors such as the broadcast media. Here the overall economic returns from

FDI are thought to be modest, sectoral insiders have significant political influence, and cultural and other concerns become salient. These findings accord with a number of other comparative and single-country studies that have shown a strong correlation between adoption of policy settings more facilitative of inward FDI and external imbalances and/or high unemployment. Discretionary controls on inward FDI are a rational mechanism for managing the fragmented and case-specific political economy of FDI as well as its nationalist sensitivities (Pokarier, 2007). Consequently, even when governments maintain a generally liberal policy, it is quite possible that transaction-specific instances of restrictions may manifest in response to domestic political pressures.

The Japanese case accords with these general analytics, yet the Japanese political economy of FDI exhibits certain distinctive features. As Wilkins (1982) and Mason (1992) have shown, Japan moved through significant periods of early openness to a heavily restrictive policy in both the lead-up to and the aftermath of World War II, and then significant liberalisation over two decades from the mid-1960s. Superficially, formal policy liberalisation shows similarities with many other countries, albeit coming earlier than in many developing countries and resource-rich states. While domestic business constituencies for liberal FDI policy outcomes were certainly always evidenced in Japan, and exercised decisive influence in some specific instances, they were never a politically stable counterweight to protectionist forces. This was in clear contrast to Anglo-American experience, for example, including even resource-based economies such as Australia and Canada.

Foreign pressures – from the US and European governments but, significantly, also from foreign firms that held key technology licences needed by Japanese industry – arguably played a more significant role than ideational change in policy liberalisation. Indeed, it is tempting to question whether such *gaiatsu* (foreign pressure) may have actually contributed to the resilient legitimacy of economic nationalist ideas even while policy liberalisation was occurring. Proponents of reform could couch it in terms of unavoidable concessions to powerful foreigners rather than articulating the potential benefits of FDI. Neither external imbalances nor domestic unemployment were factors driving substantial FDI policy liberalisation in Japan in the two decades from the mid-1960s. Japan's straitened domestic economic circumstances since the early 1990s have been a factor in formal commitments to facilitate inbound FDI, although again external imbalances are not a consideration.[11] Foreign investment was increasingly seen in the late 1990s by some

[11] Indeed Japan has shifted to running a substantial surplus on its income account in addition to its trade account, primarily through profits repatriated from foreign subsidiaries as well as royalties and licensee fees received from both them and foreign firms increasingly reliant on Japanese technologies.

policymakers and corporate constituencies as offering a potential stimulus to domestic economic revitalisation and a source of immediate assistance to deeply distressed firms such as Nissan.

3. EVOLVING JAPANESE INTERESTS VIS-À-VIS FDI

This section examines Japanese *private interests* vis-à-vis FDI.[12] It offers a sketch of revealed and potential constituencies for and against openness towards particular types of foreign investment, in accordance with the political economy framework concisely reviewed in the previous section. A concurrent concern is the extent to which established Japanese corporate practices create distinctive structures of *rational* resistance to foreign control not commonly evidenced in other nations. The specific issue of corporate interests in policy reciprocity is then considered briefly, given the internationalisation of leading Japanese enterprises, and finally attention is given to the controversial issue of triangular merger provisions. Section 4 then briefly explores evolving Japanese ideas vis-à-vis FDI, with particular regard for the ostensibly public-interest concerns raised about foreign control and notions of a 'clash of capitalisms'.

FDI into mature economies almost inevitably presents some competitive threats to existing firms. As noted earlier, Japan is formally quite open in most sectors, although the American Chamber of Commerce in Japan (ACCJ, 2003) and other foreign stakeholders identify ongoing barriers to foreign enterprises. While important, and a potential source of bilateral friction, those barriers do not provide any particular insights into the evolution of Japanese corporate governance, so they are not explored here.

3.1 Constituencies

A large literature has examined historical complementarity between the so-

[12] The terminology of 'private interests', although often entailing pejorative normative connotations in discussing particular policy settings, a priori should not do so. It simply means that material consequences accrue to concrete individuals from the perpetuation or change of particular social arrangements. Indeed 'public goods' are also experienced by their beneficiaries as private goods in which they have 'private interests' in their perpetuation. The 'public goods' dimension arises because of certain intrinsic attributes they exhibit, such as non-excludability, which in turn may have implications for their provision (or lack thereof) through uncoordinated individual choice. The pejorative dimension of 'private interests' arises when certain norms about appropriate distributional outcomes, or collective choice processes pertaining to them – such as majoritarian decision rules – are deemed to have been breached.

called relational contingent governance model of the traditional 'J-firm' and distinctive features of the regular Japanese human resource management system (for example, Aoki, 2007, pp. 438–9; Abe and Hoshi, 2007, p. 257). Firm-specific human capital has been seen as a major explanatory factor in key aspects of the J-firm, such as so-called lifetime employment and age-based wages, and its interface with financing and corporate governance practices as a whole. While the broader issues are beyond the scope of this chapter, a simple issue with the firm-specific human capital framework needs to be raised.[13] If compensation does generally reflect employees' value proposition to an enterprise, why should they be concerned about a change of corporate control? This may suggest a cognitive problem about a cognitive problem: many Japanese may fear that corporate outsiders (foreigners or other Japanese) would be unable to discern the value employees add to an enterprise, despite spending their money on buying the business. That, in itself, seems unconvincing as an explanation of widespread antipathy to outsider control, although some recent public commentary about hostile takeovers suggests such notions. Evidence has suggested that firms with substantial foreign shareholdings were more likely to downsize staff. Yet they were also more likely to be more profitable and to pay higher wages (Ahmadijan and Robinson, 2001; Ahmadijan and Robinson, 2005). There may be a more structural dimension to such fears about a foreign control event. Employees may fear that informal understandings on retirement bonuses may not be honoured by new owners. Why the current owners would honour such commitments, if it was rational for new owners not to do so, is unclear. Perhaps norms are indeed at work. In the concluding Section 5 below, some further observations are made about how core employees could conceivably capitalise residual claims in their firm, attenuating revealed concerns about potential control events.

Some Japanese commentary on the risk of foreign takeovers, as well as corporate governance generally (Nottage and Wolff, 2005), has referred to the need to consider the interests of suppliers to a target firm as stakeholders in it. Nissan's cutting of suppliers under the leadership of Carlos Ghosn drew a

[13] As this author has suggested elsewhere (Pokarier, 2002, pp. 112–22), the firm-specific human capital argument seems unconvincing as an explanation of the logic of seniority-based wages. A firm should have no need to compensate employees well above external market rates for skills sets that are not portable. Either employees' capabilities are more generic, and hence tradeable, than claimed by Koike (1987, 1988) and others or the premium earned by the employee represents some measure of rents. This may be owing to agency slack, with management by and for core-employees at the expense of shareholders, and/or it may be the price of historical compromises, given labour protections and resistance to attempts to assess and reward individual productivity.

great deal of critical attention, although its corporate revitalisation has been a boon to those suppliers that were retained (Ikeda and Nakagawa, 2002). Toyota also rationalised some of its supplier networks during the 1990s, but this attracted less attention.

The rapid growth in M&A of all kinds (in-in, in-out, and out-in) has, in turn, been a significant boost to the specialist legal, consulting, valuation and other financial services providers – Japanese and foreign – that facilitate such deals (Sibbitt, 1998; Kelemen and Sibbitt, 2002). At the same time, the foreign takeover bogeyman has been good business for the law and consulting firms in particular. The Corporate Value Report was a gift to these firms as it favoured rules that would require defences to be put in place prior to a control event. And as Kamiya and Ito discuss in Chapter 8 of this volume, the apparent finding in the *Bulldog Sauce* case that emergency defences are acceptable, but that bidders should be compensated for the costs entailed in them, may set firms up for greenmail. The evolving nature of the 'advanced warning system' of defensive measures explains why hundreds of Japanese enterprises have moved so promptly to put defence measures in place, despite the very small probability of a successful hostile control event arising during the period (compare also Puchniak, 2008).

It remains to be seen whether, on balance, these business services firms prove to be a pro-FDI constituency. The stature of legal and foreign financial services firms is being enhanced not only by the M&A boom, but also by their increasing popularity as career paths for graduates from the most elite university faculties, as from law at Tokyo University. Some Japanese firms engaged in ongoing restructuring of their enterprises do solicit buyers for non-core assets even amongst American investment funds, affirming the logic of liberal constituencies discussed above. For instance, in March 2007 Matsushita Electric entered into negotiations with a US investment fund (Texas Pacific Group) over the sale of its loss-making Victor Co (JVC) subsidiary (*Daily Yomiuri*, 17 March 2007).

The Tokyo Stock Exchange (TSE) has endeavoured to defend shareholder value principles, going head-to-head with METI and the Financial Services Agency (FSA) over the use of golden shares and 'super voting stock', METI's study panel having advocated that firms explore adopting such defensive measures (*Daily Yomiuri*, 3 November 2005). In late November 2005 TSE President Takuo Tsurushima issued draft guidelines that would effectively ban the use of 'golden shares' and make firms subject to delisting if they did not drop the measures (Kyodo in *Yomiuri Shimbun*, 24 November 2005). This earned it the ire of Financial Services Minister Kaoru Yosano, who said publicly that the FSA had no place doing so when the new Company Law would allow firms to issue golden shares. The TSE was institutionally in a weak position, though, as it ultimately needed FSA authorisation for such

guidelines, which were not to be forthcoming.[14] Predictably, the Pension Fund Association under the leadership of Tomomi Yano, a prominent supporter of Anglo-American corporate governance practices, has been a strong critic of poison pill defences and other poor corporate governance practices, and a defender of the foreign investors' contribution to the Japanese economy (*Financial Times*, 15 June 2007; *Daily Yomiuri*, 18 June 2007).

International practice suggests more efficacious means to protect the interests of target shareholders than simply requiring a poison pill defence to be endorsed at a shareholders' meeting. The development of valuation services – both incorporated into bidders' statements and provided as independent valuation reports to target shareholders – can help protect shareholder interests while leading to more bids and more responsive managements (Merrett, 2007, p. 12). Yet even then the role of management in commissioning the report, and investor complacency, may be at the expense of target shareholders.[15] Even when there is a significant will to reinforce shareholder value norms, certain legal and regulatory dilemmas arise. For instance, prioritising minority shareholder protection might entail requiring takeover bids to be full rather than partial. This can prevent the risk of two-tier offers where a premium is paid only for shares up to the point that gives control, which often favours large-block shareholders who provide early acceptances. Yet a requirement for full offers increases the overall cost to a bidder and may be discouraging, reducing pressures on managers (Merrett, 2007, p. 12). Indeed, as will be touched on below in this section, some Japanese corporate sector critics of new provisions permitting foreign subsidiaries to use shares of the parent firm abroad in M&A deals with Japanese firms (so-called 'triangular merger' provisions) were criticised on the grounds that such two-tier bids might be possible (Kyodo, 1 May 2007).

Tender offers generally lead to significant premiums for target shareholders above what the share traded for prior to the offer (Bhagat et al., 2005).[16] This

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[14] Some critics of the TSE's position, such as *Yomiuri* editorialists, subsequently questioned the bourse's decision to not delist Nikko Cordial in March 2007 for false financial reporting; at least, until they realised that it played into the hands of Citigroup, which was moving to take over its Japanese partner (*Yomiuri Shimbun*, 13 March 2007). The takeover did subsequently occur, and was the first transaction completed under new triangular merger provisions – discussed below in this section. The continued listing was conducive to the Citigroup tender being conducted in that fashion (Bloomberg, 13 June 2007).

[15] Bugeja's study (2005), for instance, found evidence that when an expert report was mandated under Australian rules shareholders earned a lower premium than when it was not.

[16] Moreover, the bidder's share price may also be enhanced owing to the positive signal the bid sends about management's cash flow expectations (Bhagat et al., 2005).

has been borne out in the share price spikes for companies targeted by Steel Partners, and even more so by subsequent share price falls after their moves for control or for managerial concessions failed. The *Bulldog Sauce* case shows this starkly. From mid-October 2007 shares traded at under 300 yen (going as low as 216 yen in the weak 2008 New Year market, but prior to the general share market slump), all substantially below the diluted-equivalent of the Steel Partners offer price.[17] Shareholder endorsements of many of the poison pill defences being put in place might still be understandable from the perspective of strengthening management's negotiating position with a potential acquirer, to the benefit of shareholders.[18] Moreover, most have provisions for shareholders to remove or renew the measures, and, in some cases, to enact the defence against a specific bidder. Yet why did so many shareholders side with the management of Bulldog in voting to deploy the poison pill defence against Steel Partners given the value of its offer?[19] Personally costly identification with the firm, loyalty to management, or hostility to Steel Partners may provide some immediate explanation. There is little evidence that shareholders would have had a reasonable expectation of earning a substantially higher return on their investments by holding. Incidentally, the basic question remains unanswered of why management, anticipating shareholder loyalty, simply did not issue a 'hold' recommendation to shareholders and avoid going down the hugely expensive path of defences. Perhaps, in fact, management did not have confidence that shareholders would remain loyal to management in their isolated responses to an offer.

The rush by Japanese firms to implement anti-takeover defences has been seen by many foreign observers as indicative of systematic managerial entrenchment. Yet M&R (2006, p. 158) are dismissive of accounts of managerial capture, arguing that market discipline should have compelled firms to adopt close to optimal governance structures.[20] Yet if this is so, why the defensive measures? As noted, poison pill defences can, in theory at least, be used by senior management to negotiate a higher premium from a bidder on behalf of shareholders, so the adoption of pill defences is not prima facie evidence of

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17 See E-Trade Japan, <http://www.etrade.ne.jp>.

18 For instance, in late March 2007 Sapporo Holdings Ltd Board won approval from a majority of shareholders for defensive measures (*Nikkei*, 29 March 2007; *Forbes*, 29/3/07)

19 In some circumstances control events can trigger tax liabilities for shareholders; yet the financial returns accruing to them should generally compensate for the inconvenience.

20 M&R (2006, p. 158) state that if 'Japanese firms suffer because insiders dominate management, then firms with more outsiders should out-compete those with fewer. They do not. Instead, exactly as basic economic theory suggests, Japanese firms apparently maintain governance structures reasonably close to what they need.'

agency slack. Moreover, managements of many firms have sought, and received, shareholder approval for takeover defences. Yet in the immediate wake of the *Livedoor–NBS* events (outlined in Dooley's Chapter 4), some 60 per cent of listed firms boosted dividend payments – albeit generally modestly – and the volume of share buybacks increased significantly (Kyodo in *Daily Yomiuri*, 19 May 2005). The *Bulldog Sauce* scenario, where management – with shareholder acquiescence – spent a very large sum to defeat a foreign takeover bid, readily lends itself to interpretation as a case of managerial entrenchment. It is consistent with recent critiques of the contingent governance model of the traditional J-firm. Managers had considerable latitude unless the firm fell into distress, which gave rise to potential agency cost problems when firms had free cash flow (Shishido, 2007, p. 311). Competitive product markets may impose a heavy discipline on managers, attenuating such risks (Merrett, 2007, p. 15). Yet the bubble economy and its aftermath revealed that such disciplines were insufficient in some sectors to prevent chronic squandering of cash that firms avoided returning to shareholders (Gourevitch and Shinn, 2005, p. 170). This implies a broader point about the 'traditional' J-firm and Japanese corporate governance in general: it provides only modest pressures for firms to shift from merely average performance to out-performance.[21] This may be further compounded by the risk averseness of core employees and managers.

On the whole, Japanese senior managers remain distinctive in generally being recruited from within the firm they joined as young university graduates (Haley, 2005b). They identify closely with the interests of the other core employees they manage, and with the company that they have invested much of their adult lives in. With external markets for general employees and managers underdeveloped, they are risk averse. The moral hazard problems of the implicit lifetime employment pledge are mitigated by intense internal tournaments for promotion to top managerial ranks (Roe, 2003, pp. 87–93). At the same time, top executives are paid much less than their counterparts in the United States, and all employee compensation is only tenuously related to performance. In part this may reflect the historical 'buying' of industrial harmony. Equally, it may entail an element of collective 'veil of ignorance' logic for core employees who, upon joining a company for the first time straight out of university or school, are uncertain as to their relative productivity. If there is 'managerial entrenchment', it is of a broad class of core employees. As noted earlier, hostile control events damage managerial reputation and, with a system of deferred compensation (such as through retirement

[21] Much of the academic literature has focused on distressed firms and the role of main banks, while much less attention has been given to averagely performing firms.

bonuses), may jeopardise both managers and general core employees' residual claims that are vested in the enterprise.[22] Gourevitch and Shinn (2005, p. 173) stress that 'employee-managers' rather than entrepreneurs have retained firm control of the organisations, such as *Keidanren*, that speak for business. The resistance of these organisations to many corporate law reforms that would bring both greater transparency and a more active corporate control market is, they conclude, a function of this structure of 'employee-manager' representation.

3.2 Reciprocity?

As seen at the beginning of this chapter, the Japanese Government and leading Japanese firms seek investment liberalisation abroad. Yet key business constituencies, as represented by *Keidanren*, seem to have less concern with openness to FDI at home for reciprocal treatment abroad than might be imagined. The likely explanation is two-fold. First, two-way FDI flows are not significant in the case of most developing countries, where Japanese firms face significant investment barriers. Second, most developed countries with which Japan does have more substantial two-way FDI flows maintain quite liberal FDI policy regimes in general. Moreover, Japanese corporate stakeholders and policymakers may perceive that the bilateral economic partnership agreement (EPA – 'FTA plus') approach might deliver investment regime liberalisations in sectors of particular concern to Japanese firms. To date, EPAs have been negotiated with developing countries that have not had significant FDI flows to Japan (Terada, 2006). Bilateral EPA/FTA negotiations currently underway with Australia may test this. This is both because Australia retains some FDI policy controls that it can make bilateral concessions on (having already done so exclusively in its FTA with the USA; see Pokarier, 2004) and because an Australian investment firm, Macquarie Airports, is at the centre of growing concerns amongst Japanese policymakers about foreign control of airport facilities after it took a 19.89 per cent stake in the publicly listed operator of the terminals at Haneda airport, Japan Airport Terminal.[23] The Macquarie

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[22] Roe sees this risk to core employees as the main reason why bank-shareholders and the lifetime employment practice proved to be good complements, whatever the particular historical drivers that initially, and somewhat independently, gave rise to both (2003, p. 93).

[23] Reuters, 27 July 2007. Land, Infrastructure and Transport minister Tetsuzo Fuyushiba flagged consideration of regulating foreign ownership in response to Macquarie's expanded stake, 'Australian fund MAP's stake in Haneda Airport raises FDI issues', Nikkei, 29 October 2007. Peter Alford, 'Map ruffles feathers with airport buy', *The Australian*, 7 November 2007; Hiroshi Matsui and Chris Cooper, 'Japan may block investors from controlling airports', Bloomberg, 5 December 2007.

Bank affiliate led a consortium that took the stake in two tranches in July and October 2007, although in May of the same year Japan Airport Terminal adopted anti-takeover defences that could be activated by an investor going above 20 per cent. That specific issue will be returned to below in the context of a further discussion of the increasing political salience of foreign control of so-called critical infrastructure. It should be noted, though, that Japanese firms have increasing stakes in key public infrastructure provision in Europe, such as in high-speed rail and power-generation, and also in the US. Over time, firms such as Toshiba and Hitachi might constitute a more influential domestic constituency, both within *Keidanren* and in the polity at large, for FDI-friendly policy.

Foreign investment policy issues certainly have become more salient in Japan's bilateral relationships with the US and the EU since the mid-2000s. Notably, there was prolonged contention over the nature and timing of reforms to permit triangular merger schemes whereby a Japanese subsidiary of a foreign firm may use shares of the parent in a takeover offer for a Japanese firm (*Japan Times*, 15 March 2005). The measures, finally enacted on 1 May 2007, did not go as far as the Europeans and Americans hoped (Kyodo in *Daily Yomiuri*, 23 April 2007). Moreover, implementation had been delayed for a year in the face of domestic opposition, and the related tax treatment issues appeared to frustrate some of the liberalising intent.[24] US Government pressure was brought to bear over the reform – the issue figuring prominently, for instance, in a bilateral official working group meeting following the 2006 APEC trade ministers meeting attended by the US APEC ambassador, Michael Michalak. He did seek to allay some Japanese concerns by saying that the US concern was with facilitating friendly mergers, and that the measures ultimately adopted effectively required the consent of both boards and shareholders. The USTR and the ACCJ maintained public criticism of the delay in, and watering down of, the merger provisions.[25] The domestic contentions regarding the triangular merger provisions were illuminating. Then Chief Cabinet Secretary Yasuhisa Shiozaki personally, and publicly, asked the MoF and METI to devise tax rules favourable to such mergers. In response *Keidanren* issued a statement calling Shiozaki's move 'deplorable' (Kyodo in *Daily Yomiuri*, 12 December 2006). *Keidanren* won some tightening of provisions, but critics saw its failure to have them abandoned as a sign of weakness under

[24] The government proposal would permit tax-deferred share exchanges only when the foreign subsidiary already operated a substantial business in Japan and was 'compatible with' prospective Japanese partners (Kyodo, 12 December 2006 translation).

[25] See, for instance, Kyodo in *Daily Yomiuri*, 7 June 2006; 7, 12 December 2006; 23 April 2007.

Fujio Mitarai's leadership (for example, *Yomiuri Shimbun*, 28 May 2007). Triangular mergers were opposed on the grounds of large market capitalisations of foreign firms giving them an advantage over Japanese firms, which entailed a certain irony as the takeover defences being widely adopted by Japanese firms at the time could have the effect of suppressing market capitalisation.

4. FDI AND THREAT PERCEPTION

While Japan's ongoing economic weakness contributes to recognition of the positive contribution that FDI might make, it also contributes to a common sense of national economic vulnerability. Recent events, and policy trends abroad, have heightened threat perceptions in relation to FDI while legitimating a discerning and defensive approach to foreign control of Japanese enterprises and assets. Posner (2004, pp. 120–22) explores the 'economics of attention' whereby complexity and uncertainty result in 'the tendency of people to attach disproportionate weight to salient, arresting events' with commensurately low 'imagination costs'. As other contributors to this volume, notably Dooley explore, some of these salient events involved Japanese entrepreneurs in bold moves to take control of other Japanese enterprises. Ironically, these Japanese events have been seen by some as unbecoming of Japanese business, and they contributed to a sense of the vulnerability of other Japanese enterprises to similar actions by foreign investors.

4.1 Public Interest Rationales for Defences against Foreign Control?

Recent arguments for defences against Japanese firms falling under foreign control often entail a variant of 'second best' reasoning, emphasising Japanese firms' relative inexperience in various aspects of the strategic management of corporate value.[26] Claimed weaknesses include managerial know-how in the areas of intellectual property, corporate structuring, investor relations and the corporate valuation function itself. The risks and costs of firm inexperience in these areas are widely seen as compounded by a shortage of expertise outside

[26] Japan has neither the federal system nor the significant natural resource endowments that have given rise to 'second best' arguments elsewhere that foreign investment in the context of poor domestic governance might result in national welfare losses. Japan's generally low trade barriers also obviate similar concerns about the economic effects of tariff-hopping FDI, although foreign investment in agriculture could be very contentious given the large rents generated by protectionist policies that currently accrue only to certain domestic constituencies.

the firm. Intellectual property (IP) protection and strategic management, for instance, is prioritised in public policy and emphasis is placed upon the development of more IP legal and management specialists.

Fears of losing Japanese technologies to abroad are often expressed within the context of discussion of FDI's impacts. *Keidanren* managing director, Masakazu Kubota, said, for instance:

> The Japanese economy is largely led by manufacturers, like those in automobile and high-tech sectors, and this country will make a living in such a business structure for the time being . . . If they become acquisition targets of overseas companies, such as those in the United States, Europe and the BRICs, their technologies will flow abroad, weakening the footing of the Japanese economy. (Kyodo in *Daily Yomiuri*, 23 April 2007)

Even more surprising, and illogical, are assertions that foreign control of Japanese firms may jeopardise the supply chains of domestic firms. Again, *Yomiuri* commentary is illuminative. In the Yomiuri editorialist's view (28 June 2006), 'if a Japanese steel company were to become a subsidiary of a foreign company, the nation's production system may suffer'. Economics commentator Junichi Maruyama concluded that, following the production delays experienced by automakers in the wake of the Chuetsu earthquake, which damaged the facilities of piston ring manufacturer Riken, the 'more serious problem is that the world now knows Japan's automobile industry could be paralysed only by the takeover of a single parts maker'.[27]

Predictable arguments are made that the weak yen would see prime Japanese corporate assets acquired at fire sale prices, although a perceived lack of domestic investment opportunities is a significant factor in the 'yen carry trade' and weak yen.[28] Japan is now well clear of the bargain-hunter period in the aftermath of the bursting of the bubble economy. Nonetheless, foreign acquisitions at that time made a contribution to much-needed work-outs and restructuring. Some valid concerns do arise about the institutional architecture of Japanese share markets, such as the lack of transparency of share ownership.[29] In such an environment, managerial fears of stock manipulation and unfair takeover bids make some sense, although the first-best argument of better

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[27] Junichi Murayama, 'Earthquake laid carmakers low', *Daily Yomiuri*, 1 August 2007.

[28] The so-called 'carry trade' entails borrowing in yen at prevailing low interest rates, buying foreign currency and then investing in higher-yielding foreign assets, typically of a liquid nature such as bonds. It has been as a significant contributor to the weakness of the yen exchange rate against higher-yielding currencies such as the Euro and the Australian dollar.

[29] Tetsuyuki Yoneyama, 'Share ownership a well-kept secret', *Daily Yomiuri*, 21 December 2005.

market regulation clearly should prevail.[30] In 2007, concerns were raised about the potential influence of so-called sovereign funds, investment outfits controlled by foreign state institutions that manage pension funds, foreign reserves and/or record earnings from resource industries.[31] Sovereign funds seem to have become topical primarily because of the attention they are attracting in the US and elsewhere. Factors include significant Middle Eastern oil revenues being directed to financial markets abroad, and the announced intention of Chinese authorities to seek higher returns on some of its foreign reserves through diverse investments.

National security arguments are becoming more politically salient in relation to inward FDI into Japan, as seen in the deliberations of the so-called METI study group on the 'international investment environment in an age of globalization of economies'.[32] It advocates a strengthened advance notice (to government) system when foreign firms take over or gain stakes in Japanese firms, away from the current sensitive sector system to a more general system with a minimum 30 days' notice (*Daily Yomiuri*, 3 May 2007). The screening system would focus upon particular industrial items rather than sectors and is premised on the US Exon-Florio provisions of the US Defense Protection Act; but may, in practice, work more like Australia's Foreign Investment Review Board prior to substantial liberalisation of notification provisions.[33] Potential foreign control of critical infrastructure is also attracting government scrutiny, with airports emerging as contentious. Even prior to Macquarie Airports' acquisition of a nearly 20 per cent stake in the Haneda airport terminal operator, moves were afoot within bureaucratic circles to enact restrictions on FDI in airport facilities. A March 2007 Construction and Transport Ministry advi-

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[30] There are parallels with the contentious issue of a register of foreign-owned land in the Australian state of Queensland in the 1980s: its final implementation actually revealed substantially lower foreign control than anticipated, and ironically, given the mix of nationalist and political motivations its advocates evinced, helped to reduce community concerns about FDI (Pokarier, 2004).

[31] At the same time, the strategies of sovereign funds such as Singapore's Temasek Holdings – with diverse investment stakes in Japan – and Norway's Government Pension Fund are attracting the attention of some Japanese Diet members and academics who advocate more active investment of Japan's large forex reserves. (Yasushi Azuma, 'More active forex reserve investment pushed', Kyodo in *Daily Yomiuri*, 1 January 2006).

[32] The study group is chaired by Professor Shujiro Urata of Waseda University, whose past academic work is positive about the contribution of FDI to economic growth.

[33] The recently introduced triangular takeover provisions provide a pretext for new screening measures of foreign control events; current controls under the Foreign Exchange and Foreign Trade Law are insufficient because no foreign currency transfers may be involved in an acquisition.

sory panel report on privatisation of Narita International Airport Corp., Chubu Centrair International Airport Corp. and Kansai International Airport Co. concluded that 'It is necessary to prevent foreign entities from obtaining control and investment funds from conducting hostile takeovers', as the airports constitute 'social infrastructure indispensable to the nation's economic activity and citizens' life' (Kyodo in *Daily Yomiuri*, 29 March 2007). Regulatory caps on foreign equity and issuance of 'golden shares' were both advocated.

The perceived threat of foreign takeovers has made 'national champion' ideas more salient, with significant implications for domestic competition policy. Mittal Steel's takeover of Arcelor was an 'arresting event', creating as it did the world's largest steelmaker with – as a worried *Yomiuri* emphasised – crude steel output three times that of the world number three, Nippon Steel.[34] The *Yomiuri* was a strong proponent of a METI proposal to relax the domestic market dominance test for mergers to 50 per cent, from the 35 per cent generally imposed by the Fair Trade Commission (*Daily Yomiuri*, 28 June 2006). Debate over weakening competition policy was further galvanised by METI and *Keidanren* open opposition to the FTC's proposed merger impact index (HHI – Herfindahl Hirshman Index), despite it entailing higher market dominance test thresholds than apply in Europe.[35] In a significant development, FTC officials subsequently indicated a preparedness to accept domestic market dominance if global market share was not above 50 per cent (Kyodo in *Daily Yomiuri*, 1 February 2007). FTC activism instead seems to have shifted to consumer protection and to guarding small subcontractors to large domestic firms.

4.2 Clash of Corporate Civilisations?

Ahmadjian and Robbins (2005) titled a paper on foreign shareholders and corporate restructuring Japan over the 1990s 'A Clash of Capitalisms'. Buchanan (2007, p. 33) subsequently notes, though, that defences of the 'J Firm' and 'internalism' are increasingly couched in terms of their long-term positive implications for shareholders, which, he states, 'demonstrates how new concepts can insinuate themselves'. The new Company Law and associated reforms perhaps will permit contending conceptions of ideal managerial and governance forms to be put to the market test. Yet hostile corporate control

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[34] *Daily Yomiuri*, 28 June 2006. As seen earlier, Nippon Steel entered a defensive agreement with Sumitomo Metal Industries and Kobe Steel against potential takeovers, cemented with some measure of cross-shareholdings.

[35] Chiaki Toyoda, 'Mixed response to new merger impact index', *Daily Yomiuri*, 15 January 2007.

events are frequently criticised as incongruous not just with Japanese corporate culture but with Japanese values more generally. Several *Yomiuri* editorials couched critique of foreign and/or domestic hostile takeover bids in terms of rejection of 'money worship' and 'market fundamentalism', resorting on one occasion to quoting from the best-selling – and breathtakingly inane – book by Professor Masahiko Fujiwara, *Kokka no Hinkaku* (Dignity of a Nation).[36] Rather ironically, such neoconservative accounts are aptly summarised by the old English adage about 'knowing the price of everything and the value of nothing'. In 2007 the hostile takeover bid, and its contested meanings, became part of mainstream entertainment fare. On Saturday nights in February and March, for instance, NHK screened the drama *Hagetaka* about a vulture-like foreign-backed private equity fund making a bid for control of a Japanese firm. Even NHK's morning drama serial ended with a climactic struggle for control of a traditional Japanese inn between a foreign investment fund and characters in the show.

For Japanese still unsure what to think of foreign investors taking control of Japanese firms and assets, a number of rather authoritative sources are at hand to lure them into antipathy. The adoption of defences by so many leading enterprises in itself lends considerable legitimacy to concerns about foreign takeovers. Having two broadcasting media groups – Fuji Television/NBS and TBS – being prominent targets of hostile control bids, albeit domestic, was bound to make such corporate control issues prominent. With their subsequent adoption of anti-takeover measures, and with the likes of TV Tokyo and other media firms mulling similar moves, their public acceptance is scarcely surprising.[37] In a more speculative vein, it may be that a *zeitgeist* of mild economic nationalism is compounded by a communicative style in both official documents and public commentary. These often exude assumptions that statements in Japanese are consumed exclusively by a Japanese audience. This is both evinced by, and reinforcing of, first person plural

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[36] The *Yomiuri Shimbun* editorial was reproduced, as usual, in English in the *Daily Yomiuri* the day after appearing in the Japanese original (26 December 2006). Fujiwara's work is a mish-mash of clichés about the Japanese character and its decline under recent influences such as flawed Western economics, materialism, liberal education, and more besides, but concludes that the Japanese can ultimately preserve the dignity of their nation and save humanity in the process (Fujiwara, 2007, pp. 276–8). It is a surprising work for a teacher of mathematics at Ochanomizu University, and an even more surprising bestseller.

[37] Foreign portfolio investors nonetheless find broadcasting firms promising investors, with Asahi Broadcasting Corp, for instance, having 15.9 per cent of its shares held by foreigners in March 2005. Its second largest shareholder after the *Asahi Shimbun*, which held 14.1 per cent, was US investment firm Liberty Square Asset Management with an 8.2 per cent stake (*Daily Yomiuri*, 7 May 2005).

possessive pronoun and adjectival forms (for example, 'Our nation's' [*wagakuni no*]). The distinction is subtle but significant: readers – if Japanese – are more likely to have feelings of empathetic in-group identification than if statements referred to, for instance, 'Japan's firms'. As de Cillia et al. (1999, p. 160) concluded in relation to the findings of a study of the discursive construction of Austrian national identity, persuasive linguistic devices are often at work 'which help invite identification and solidarity with the "we-group", which, however, simultaneously implies distancing from and marginalization of "others"'.

Yet in-group/out-group identification typically is not a normal cognitive state; it becomes salient only in response to particular negative stimuli. Neither are potential in-group identities singular: individuals have a plurality of potential group identities that may contend in particular circumstances. While nationality and its associated language-group and cultural identity are a natural divide, common industry and professional identities can attenuate this. Investment fund takeovers of firms may cut across industry identities within the same national grouping; hostility to 'the suits' are legendary in Anglo-American artisanal, technical and creative circles. On the other hand, historical intra-industry rivalries can be the making of some of the most bitter control events of all. The recent domestic bids involving Oji–Hoketsu, Aoki Holdings–Futata, and Hoya–Pentax (Puchniak, 2008) provide insights into the scope for contention. There may indeed be a 'liability of foreignness', but significant too is the manner of their bidding. Outsiders should at least ask first.

5. CONCLUSIONS

Recent Japanese public policy developments potentially impact negatively on foreign investors in two ways. One is through expanding Japanese firms' latitude for adopting private defensive means against unwelcome control events brought by outsiders (foreign or Japanese). The second is through imminent expansion of 'at the gate' screening and specific restrictions in relation to sensitive sectors. This chapter opened by sketching three hypothetical accounts of the determinants of this policy mix. All were predicated upon a model of political markets where state actors (legislative and bureaucratic, in complexly inter-dependent relationships) supply policy compromises in response to (frequently contending) constituency demands. These demands may be motivated by material private interests and ideas about how to protect and advance them, or more public-interest-oriented ideas. Influential ideas need not be good ideas, and economic nationalist ideas rarely accord with contemporary academic understandings of FDI's impacts.

As shown above, evidence can be mustered both for and against each

explanation. The first, privatisation of economic nationalism, envisages an economic nationalist state pursuing (essentially in duplicitous fashion) investment policy liberalisation abroad, in keeping with the interests of Japanese firms. It devolves the task of minimising foreign control of Japanese enterprises to firms through such private measures as new defensive cross-shareholdings, poison pills and golden share arrangements. Evidence in favour of this account includes a number of official statements from METI and elsewhere linking such defensive measures to broader issues about guarding Japan's competitive advantages in knowledge-intensive industries, and expressing the view that retaining Japanese control is important to that. Such views have been expressed frequently also by leading corporate representatives and are echoed by numerous public commentators.

Evidence against this are other official policy statements which clearly enunciate how FDI, including inbound M&A, can make a positive contribution to the economy. So are the voluntary nature of 'privatising' measures of foreign control, the role of the judiciary in clearly protecting foreign (and domestic so-called 'hostile') shareholders against disenfranchisement without compensation, and the liberalisation of restrictions on cross-border triangular mergers. Yet the latter can also be explained as a consequence of *gaiatsu*, and US pressure in particular. The notion of 'privatising' economic nationalism also does not capture recent moves in the direction of more FDI screening and sector-specific restrictions, although these policy developments have some precedent in the US and elsewhere.

The second hypothesised account, described as discretionary public interest, entails a similar political logic of devolution of action regarding foreign control to firms. Significantly, it envisages governments leaving the decision to resist or embrace foreign ownership and control to the discretion of corporate leaderships, in the context of contending ideas about the pros and cons of foreign ownership and control. Evidence for this includes firms' freedom to choose since 2004 between the external director and committee-based governance model and the statutory auditor approach (explored in Lawley's Chapter 6). Many firms that have adopted the former have been proactive in engaging with the international portfolio investment community.

Yet firms have only so much latitude for economic nationalism. As noted, the judiciary constrains the latitude of managers to dilute foreigners' shareholdings without compensation, and no legislative measures to tilt the playing field further against foreign investors in this respect seem to be forthcoming as of early 2008. How the law evolves in relation to the treatment of investors, foreign or domestic, deemed to be 'abusive acquirers', will be significant. Whether the legislature lets stand the broad – and, from an economic perspective, highly dubious – conception of an abusive acquirer adopted in the *Bulldog Sauce* judgments, is likely to matter greatly to the latitude firm

managers have in enacting defences against hostile bidders, and to how they are perceived in the Japanese community at large.

The third hypothesised account, termed discretionary private interest, is essentially a standard political market theoretical account of contention between domestic economic constituencies for and against a liberal inward FDI regime being mediated through the public policy process. As I have explored elsewhere, the case-specificity of FDI interests, state interest in economic growth, and international policy reciprocity as a consideration generally lead governments to prefer discretionary policy instruments (Pokarier, 2004, 2007).

All three accounts share a common conception of the workings of political markets and have complementary dimensions. As seen in Section 2, sincerely held economic nationalist ideas in policy circles or the community give licence to private rent-seeking by those whose interests may be threatened by foreign investment. Orthodox rent-seeking regarding FDI, namely sector-specific foreign equity caps or heavily conditional 'at the gate' screening that delivers rents to domestic interests, is not much evidenced in contemporary Japan, except perhaps for the media and several other sensitive sectors. The second account comes closest to according with North's notion of adaptive efficiency if, and only if, the managements of firms making choices are not simply entrenched and self-serving. Intense competition in product markets serves to discipline management and workers, and an interesting test of alternative models of corporate governance for Japanese firms would be between firms going head-to-head in the same markets. Yet regulatory factors still constrain competition in some sectors, and this may both lessen disciplinary pressures upon managements and diminish incentives to innovate governance practices.

All three accounts also highlight the effective devolution by government of discretionary responses to foreign investors to the private sector, in a fashion not dissimilar to that seen when FDI policy was first liberalised in the mid-1960s. Only time will tell whether this devolution of discretion creates informal barriers to foreign enterprise, as argued by Schaede (2003), or ultimately will be facilitative of the adaptive efficiency identified by North (2005) as essential to sustainable economic growth. Many of the recent changes in corporate law and regulations that permit new organisational and governance forms and practices might be described as potentially *dual use*. That is, depending on their application, they might serve to strengthen the accountability and efficiency of managements or further entrench them. Share buybacks, for instance, return spare cash to shareholders and boost the share price, but can also entrench managers by taking shares out of the hands of those who would be most likely to sell to a hostile bidder. Japanese firms actively engaged in share buybacks once permitted by corporate and tax law

changes (as outlined in the Appendix to this volume's introductory chapter), but they have also been undertaken as an explicitly defensive measure (*Daily Yomiuri*, 17 June 2006). The holding company form is another instance, as TBS showed in early 2008 with its announced plan to both effect a substantial restructuring of its business group and to strengthen defences against hostile takeovers. This is abetted by the recently revised Broadcasting Law (No. 136 of 2007), which caps a single shareholder's stake in a broadcaster's holding company at no more than one-third (*Yomiuri Shimbun*, 3 January 2008). Foreign investment limits, which cap total foreign equity stakes at 20 per cent, were also extended to such corporate entities following the Livedoor–NBC imbroglio and Rakuten's move on TBS.[38] As firms seek to restructure their corporate organisations, to structure new deals in innovative ways, there is an almost inevitably cyclical process of regulators responding to apparent evidence of loopholes in existing provisions. This is certainly not a distinctively Japanese phenomenon, but highlights the ongoing compliance and enforcement costs that can be entailed in foreign investment regulatory regimes.[39] From an adaptive efficiency perspective, signs of a new restrictiveness in formal 'at the gate' FDI regulation for sensitive sectors and ostensibly critical infrastructure bode ill, not least because they relate directly to some of the least efficient sectors of the Japanese economy that are nonetheless critical to overall economic efficiency.

Several further normative conclusions can be drawn. These relate principally to leadership, both intellectual and political, and to the oft-assumed egalitarianism of stakeholder capitalisms. Good information on the extent, costs and benefits of FDI has been shown in other studies to have an important role to play in attenuating what are probably natural community concerns about foreign investment. Yet such information is already at hand in Japan. Intellectual leadership that summarises and disseminates understanding about

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[38] Rakuten's proposal to merge its business group with TBS under a joint holding company stimulated a government response to extend the 20 per cent foreign stake limit in broadcasting licence holders to include shares held in such holding companies (*Yomiuri Shimbun*, 27 October 2005). This would suggest that non-broadcasting assets, such as Rakuten's internet mall business, should be separately listed in order not to diminish its attractiveness to foreign investors but would impact on Rakuten's proposed corporate organisation model. In May 2005, the Radio Law and Broadcasting Act was amended to ensure the 20 per cent foreign equity cap also covered foreign shareholdings in Japanese firms that may, in turn, own shares in a broadcaster (Koichi Uetake, 'Bills cap foreign firms' influence over media', *Daily Yomiuri*, 4 May 2005).

[39] For instance, Australia's foreign investment and competition policy controls applying to the media evolved in a similar fashion over a decade from the mid-1980s, then settled into a new equilibrium for another decade before new significant reform occurred.

the relatively small role FDI plays in the Japanese economy and its potential benefits even in sensitive sectors – such as airports – remains important. Sometimes ideas can change political economy through a behavioural feedback loop that can be either virtuous or destructive. For instance, the relationship between share market performance and retirement incomes is not widely thought-of in Japan as most people are in defined benefits retirement income schemes, whether state provided, corporate schemes, or privately purchased annuity-type products sold by life insurance firms. Shareholder value ideas will have less resonance in such an environment, and the 'transparency coalition' of owner–worker interests in relation to corporate governance identified by Gourevitch and Shinn (2005, pp. 205–76) is far less likely to emerge. Intellectual leadership in this respect is much needed.[40]

The ending of the so-called bubble economy and the associated asset price deflation cast a pall over corporate retirement funds, scaring off much Japanese direct share-holding and making cash king. In the third quarter of 2007, shares and other capital investments still accounted for only 11.3 per cent of Japanese household financial assets, by comparison with 31.2 per cent in the United States. While investment trust and mutual funds were becoming somewhat more popular, they only amounted to 5 per cent of assets, in contrast to 14.3 per cent in the US. Cash/savings accounted for 50.2 per cent of all Japanese household financial assets whereas they amounted to only 13 per cent in the United States.[41] Any positive impact that the current temporary discounted tax rates applying to dividends and capital gains had on the preparedness of Japanese individuals to directly hold equities has been more than offset by the 'Livedoor shock' (outlined in Dooley's Chapter 7) and poor share market performance from 2004 to early 2008. Chronic mismanagement of public pension funds was a prominent issue in the ruling coalition's defeat in the 2007 Upper House election and compounded public insecurities about the security of future retirement incomes. In theory, this could be an impetus to a growing shareholder value orientation. In practice, coupled with poor share market performance, it favours hoarding of cash and compounds potentially recessionary pressures in the economy. There are conceivable public policy responses to promote shareholder orientation at large. For instance, tax incentives favouring performance-contingent retirement funds over defined-benefit arrangements would expand both demand for equities and promote a

[40] Not surprisingly, Nomura Holdings Chairman Junichi Ujiie has been vocal in arguing that there is a need to shift savings from the banking sector to equity markets to address the retirement incomes challenge (*Daily Yomiuri*, 8 November 2006).

[41] Kenya Hirose, 'Households investing more money', *Daily Yomiuri*, 24 December 2007.

broader sense of stakeholdership in share market performance.[42] It would also draw attention to who bears risk, and would require intellectual and political leadership.

In addition to harnessing the insights of intellectual leaders on foreign investment, political leadership should eschew the temptations of second-best arguments for defensive measures against foreign control, pursuing instead first-best reform. If reform were done, 'twere well it were done quickly – with maximum positive announcement effect. The cross-border triangular merger provisions were drafted and publicly flagged, only for their implementation to be suspended for a year in the face of *Keidanren* opposition and demands that firms be given time to put defences in place prior to their implementation. Their ultimate enactment, as a seemingly grudging concession to foreign pressure, compounded the Japanese Government's reputation in the international business community for its ambivalent approach to economic openness.[43] This reputation problem (perhaps untroubling to a few staunch economic nationalists) is reflected in indices such as the 2007 IMD International Competitiveness rankings, in which Japan fell to 24th place, and the recent 'Japan passing' phenomenon – with foreign portfolio investors showing sharply diminished interest in Japanese assets.

Positive country reputation does have certain public-good-like properties, and this suggests a broader problem with giving firms the latitude to disenfranchise foreign investors. It is ironic also given the Japanese Government's ambitious 'Gateway to Asia' vision of the nation as a key services hub for Asia: 'the London of Asia', in the words of University of Tokyo Professor Takatoshi Ito, who serves on the Council on Economic and Fiscal Policy.[44] Political leadership would address the incongruity of promoting the Gateway to Asia policy while simultaneously considering means to limit foreign investment in airports. Finally, Japanese political leadership on FDI policy would also give explicit recognition to how, in the late 1980s and early 1990s, Japanese enterprises were significant beneficiaries of political leadership

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[42] As wealthier individuals have a greater capacity to bear financial risk this alone might defer additional advantage upon them. Consequently it would need to be part of a more comprehensive reform, means-testing and targeting, of retirement incomes policy.

[43] It was, for instance, in striking contrast to use by the Hawke and Keating governments in Australia of unexpected FDI policy liberalisation measures as a mechanism to signal to the international business community its ongoing commitment to economic reform.

[44] The so-called Urban Renaissance Headquarters and the Financial Services Agency were tasked with establishing a new English-language-friendly international financial services hub around Tokyo station, based on the City of London (*Daily Yomiuri*, 5 May 2007).

abroad. Governments in Australia, the US and the UK in particular resisted domestic politicisation of Japanese FDI and maintained liberal and non-discriminatory policy settings (Pokarier, 2004).

A political market approach is predicated on the notion that structures of interests give rise to demands for regulatory and institutional arrangements for their protection and advancement. A corollary of this is that institutional innovation at the firm level in Japan might obviate the need for political action in relation to FDI, and enhance rather than retard the adaptive efficiency of the economy. It might bring the interests of at least some stakeholders in the J-firm, currently often seen as at odds with those of potential foreign investors and acquirers, into some alignment. For instance, if core employees are indeed, in a sense, residual claimants in a firm (that is, not fully compensated parties via the salary mechanism), then an expansion of employee share schemes in place of other deferred compensation mechanisms may attenuate employee concerns about a control event. Such an approach, essentially capitalisation of deferred compensation, would be consistent with the vision of a transparent new J-firm, led by a 'bargaining board', sketched by Shishido (2007, pp. 325–7). It would cement the corporate community ethos praised by many defenders of the traditional J-firm while retaining, and indeed strengthening, the contingent and motivational aspect of such deferred compensation.

At the same time, as stressed in Wolff's Chapter 3, fewer and fewer Japanese are regular stakeholders in the firms that ostensibly epitomise the Japanese variant of stakeholder capitalism. The insiders in the 'insider firm' increasingly are a somewhat privileged minority. They have been recruited typically through formally meritocratic educational tournaments, although more and more predominantly from the middle and higher classes. Dore (2007, p. 395) noted that after six generations of meritocracy, three with expanded educational opportunity, 'class divisions in Japan are hardening and the intergenerational transmission of class status is increasing'. In 2006 the term '*kakusa shakai*' – a society of divides or inequalities – gained wide currency, with both left- and right-wing critics seeing it as the legacy of former prime minister Koizumi's ostensible 'market fundamentalism'. Yet as Genda (2006) and the OECD (2006, p. 8) suggest, the most pronounced contemporary economic divide is between protected permanent core employees and non-permanent staff (*Daily Yomiuri*, 28 June and 21 July 2006). The Cabinet Office's 2006 and 2007 annual reports on the Japanese economy acknowledge the widening gap between rich and poor. What some depict as a struggle to defend the egalitarianism of Japanese stakeholder capitalism, against the ruthless efficiency of shareholder-oriented Anglo-American capitalism, may increasingly come to look like the defence of Japanese middle-class insider interests – at the expense of other Japanese and foreign investors alike. Breton (1964, p. 379) cautioned similarly against economic nationalist ideas as long ago as the early 1960s.

10. Conclusions: Japan's largest corporations, then and now

Souichirou Kozuka

It seems like only yesterday. At the end of the 1980s, Japan's economy was booming and its companies were making huge profits. Commentators argued for a 'Japanese' model of capitalism, an alternative to the Anglo-American model. Some academics tried to uncover the seemingly successful mechanisms underpinning the Japanese economy. Others criticised the alleged unfairness of Japanese socio-economic ordering that produced such prosperity.

During the ensuing two decades, however, Japan experienced political and economic turmoil. The world's attention has turned increasingly to the new economic powers – including China, Japan's huge neighbour. The Japanese are reportedly uneasy about their lives and future prosperity. The US is regarded as the prototype for a successful market economy, while the Japanese model appears to have lost much of its attractiveness to overseas researchers.

Yet the two decades since the bursting of the bubble economy have been an era of extensive law reform in Japan. As detailed in this book's introductory chapter, corporate law has gone through repeated reforms and amendments. This culminated in the enactment of the new Company Law (No. 86 of 2005), spun off from the century-old Commercial Code (No. 48 of 1896). Other business law has also been subject to constant reform. Securities regulation, for example, now centres on the Financial Instruments Exchange Law (No. 65 of 2006), renamed and enlarged in scope of application to regulate all types of investment products.

These two simultaneous trends, namely the widespread sense of decline in the attractiveness of the Japanese economy and the large-scale law reforms, might lead some to a simple and seemingly persuasive conclusion: Japan has been making efforts to change, perhaps by following the path of the US, to regain its lost status. The preceding chapters in this book, however, have shown that things are not so straightforward. In some respects, the Japanese economy did try to adapt to the changes in the global economy, and law reform was needed for such adaptation to be successfully achieved. In other respects, however, the law developed in a uniquely Japanese way, either due to the

domestic politics or as a result of court decisions that were more independent of the political and economic contexts.

Echoing this book's theme of 'gradual transformation', elaborated in Nottage's Chapter 2, I too explore whether and to what extent the law and practice in Japan actually changed over the last two decades, and consider how developments in each affected the other. Section 1 examines some data collected from corporate databooks[1] to see whether there were any radical changes at least in blue-chip companies. Section 2 delves into more specific data, namely these companies' major shareholders, debt–equity ratios, and numbers of employees. Section 3 relates these to law reforms in corporate governance. Previous chapters have already looked in more detail at almost all these issues, but I locate them within a broader perspective highlighting an ambivalent mixture of socio-economic changes and continuity in Japan. My conclusions, therefore, may not seem so exciting; but, often, such is life. Gradual but incremental changes are taking place, in somewhat inconsistent ways, which may cumulate some day in a large shift. Developments in Japanese law both reflect, and play some role in causing, such changes.

1. JAPANESE COMPANIES: FROM 1988 TO 2008

1.1 The Top 40 Companies, Then and Now

Since Japanese companies were often praised in the 1980s, it seems appropriate to start by comparing the major companies then with those now. Table 10.1 shows the Top 40 companies as measured by aggregate market value in 1988 compared with 2008.[2] From the Top 40 of 1988, 23 remain in the list for 2008, including 13 companies (mostly financial institutions) appearing with a different name as a result of having integrated with others by mergers and/or having joined a corporate group under a holding company.[3] In addition, 15 others rank within the Top 100 of 2008. Thus, most of the blue-chip companies from the peak days of the Japanese economy are still major companies in Japan.

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[1] There are two major series of corporate databooks in Japan: the *Kaisha Shikiho* (Japan Company Handbook, published quarterly by Toyo Keizai) and the *Nikkei Kaisha Joho* (Nikkei Corporate Data, published quarterly by Nikkei Publishing). Data analysed in this chapter were collected from the first issues for 1988, 1993, 1998, 2003 and 2008.

[2] Toyo Keizai (1988, p. 1160; 2008, p. 2121).

[3] See Table 10.2 below for more details on holding companies among the Top 40 in 2008.

Table 10.1 Top 40 Japanese companies, ranked by aggregate market value

1988	2008
NTT; Tokyo Electric Power Co.; Sumitomo Bank; Daiichi Kangyo Bank; Fuji Bank; Mitsubishi Bank; Industrial Bank of Japan; Nomura Securities Co.; Sanwa Bank; Toyota; Matsushita Electric; Mitsui Bank; Long-Term Credit Bank of Japan; Hitachi; Tokai Bank; Mitsubishi Trust Bank; Sumitomo Trust Bank; Kansai Electric Power Co.; Nippon Steel; NEC; Tokyo Gas Co. Ltd; Daiwa Securities; All Nippon Airways; Mitsubishi Estate; Nikko Securities; Tokio Marine and Fire Insurance Co.; Japan Airlines; Tokyo Bank; Takeda Pharmaceutical Co.; Chubu Electric Power Co.; Mitsui Trust Bank; Ajinomoto Co.; Taiyo Kobe Bank; Asahi Glass Co. Ltd; Yamaichi Securities; Fujitsu; Kirin; Toshiba; Daiwa Bank; Mitsubishi Heavy Industries	Toyota; Mitsubishi UFJ Financial Group; Nintendo; NTT DoCoMo; NTT; Canon; Sumitomo Mitsui Financial Group; Honda; Mizuho Financial Group; Takeda Pharmaceutical Co.; JT (Japan Tobacco); Sony; Matsushita Electric (Panasonic Corp.); Nissan; Mitsubishi Corp.; Mitsui & Co.; Nippon Steel; Denso; Tokyo Electric Power Co.; Mitsubishi Estate; East Japan Railway Co.; Nomura Holdings; KDDI; JFE Holdings; Yahoo Japan; Komatsu; Millea Holdings; Toshiba; INPEX Holdings; Fanuc; Kansai Electric Power Co.; Softbank; Shin-Etsu Chemical; Seven and i Holdings; Mitsubishi Electric; Daiichi Sankyo; Central Japan Railway Co.; Hitachi; Astellas Pharma Inc.; Fuji Film Holdings

Source: See footnote 1

Looking at the same data from the viewpoint of 2008, 15 of the Top 40 companies are either ranked within the Top 40 in 1988 or are their successor companies, and 13 others ranked within the Top 100 in 1988. Only six of the Top 40 companies nowadays were newly established or listed over the intervening two decades, and three of them are former state-owned enterprises that have been privatised.[4] This leaves only three that really deserve to be called 'new entrants'.[5]

One plausible conclusion is that Japanese industry remains relatively stable with little turnover in the leading companies. Two evaluations could be made.

[4] JT, East Japan Railway and Central Japan Railway.

[5] NTT DoCoMo, Yahoo Japan and Softbank. Note that NTT DoCoMo was established by a divestiture from another former state-owned enterprise, NTT.

One is that the Japanese economy in reality has not changed much since the 1980s, so that the radical decline in its reputation is an overreaction. An alternative view might see the very reason for the stagnation of Japanese economy as the absence of dynamism created by new entrants. Whatever position is taken, the starting point should be that there has not been much change among Japan's big companies, which are the major users of Japanese corporate law.

1.2 Increase in Corporate Restructuring

Table 10.1 shows that many of the Top 40 companies in 2008 are holding companies. As detailed in Table 10.2 below, most of them are 'pure holding companies', engaged in no particular business other than managing and controlling a corporate group. Pure holding companies had long been prohibited under the Antimonopoly Law (No. 54 of 1947), as they were perceived as likely to lead to the revival of the undemocratic control of the economy achieved by the *zaibatsu* before World War II. The prohibition was lifted in 1997 following strong pressure from industry. Thereafter, amendments to corporate law have gradually amplified the methods for restructuring companies (as outlined in the introductory chapter's Appendix). Previously, other than the straightforward acquisition of shares, only the merger procedure was available for a company acquiring another. Now the Company Law provides for share-for-share exchanges and share-transfers, as well as demergers. If the acquired company is either relatively small or almost totally controlled by the acquiring company, a simplified procedure is available and a shareholders' meeting can be skipped in some cases.[6] Looking back, it is fair to say that one of the aims of the frequent amendments to corporate law since the late 1990s was to enable Japanese companies to carry out smooth restructuring of companies and the establishment of new corporate groups.

Corporate groups sometimes adopt a holding company structure due to the regulatory environment. For financial institutions, in particular, this could be the case because they need to have a subsidiary for each sector in which they offer services.[7] Table 10.2 shows, however, that holding companies are chosen not merely to respond to the regulatory environment, as their predecessor

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[6] For technical explanations of these procedures, see Kozuka and Wolff (2007. paras 16-700 to 16-850).

[7] Even after the segregation of banking and securities industries was finally abolished in 1998 (Kozuka 2005), a bank can engage in the securities business not by itself (FIEL, art. 33) but only through a subsidiary (Banking Law, No. 59 of 1981, art. 16-2). Therefore, if a financial institution is going to offer the full line of financial products, it is convenient to have a holding company that holds subsidiaries, each of which specialises in a line of services.

companies include more than one institution in the same business. For example, the Mitsubishi UFJ Financial Group is a conglomerate that five commercial banks and three trust banks have joined. Thus, it is more plausible that the holding company has been used for consolidation of competitors in the same market. More recently, this trend has spread to other types of companies, as evidenced by the JFE holdings (steel manufacturing), Seven & i Holdings (distribution conglomerate) and Daiichi Sankyo (pharmaceutical manufacturing).

Table 10.2 Pure holding companies among the Top 40 of 2008

Company name	Major predecessor companies[1]
Mitsubishi UFJ Financial Group	Mitsubishi Bank, Tokyo Bank, Sanwa Bank, Tokai Bank, Mitsubishi Trust Bank, Nippon Trust Bank, Toyo Trust Bank
NTT	
Sumitomo Mitsui Financial Group	Sumitomo Bank, Mitsui Bank, Taiyo Kobe Bank
Mizuho Financial Group	Fuji Bank, Daiichi Kangyo Bank, Industrial Bank of Japan
Nomura Holdings	
JFE Holdings	NKK, Kawasaki Steel
Millea Holdings	Tokio Marine and Fire Insurance, Nichido Fire Insurance
INPEX Holdings	Inpex Corp., Teikoku Oil Co.
Softbank	Nippon Telecom, (Vodafone Japan)
Seven & i Holdings	Ito-Yokado, Seven-Eleven Japan, York-Benimaru, Sogo, (Seibu Department Store)
Daiichi Sankyo[2]	Daiichi Pharmaceutical, Sankyo Co.
Fuji Film Holdings	Fuji Film, (Fuji Xerox)

Notes

1. The companies listed in this column are basically those included in the first issue for 1998 of the *Kaisha Shikiho*, which means that they were listed companies at that time. A company in parentheses is a well-known group company that was not listed.
2. Established as a pure holding company, but now engaged in production and marketing.

Source: See footnote 1

Some other companies among the Top 40 of 2008 have gone through integration with their competitors[8] or other types of restructuring.[9] Integration with competitors usually takes place as a result of competitive pressure from the product market. Thus, the establishment of holding companies and other types of restructuring appears to be a response by Japanese companies to the globalisation of markets. Further, a significant part of the corporate law reforms over the last two decades was needed to enable such responses.

2. THE CURRENT STATUS OF THE JAPANESE MODEL OF CAPITALISM

Having confirmed that the Japanese blue-chip companies largely survived the last two decades, the next issue is whether their management mechanisms have changed. I make use of the corporate data for the Top 40 companies of 2008 and trace them back to 1988.[10] I do not undertake a detailed quantitative analysis. Instead, I describe several clear trends in three areas. First, I look at the major shareholders of each company to see whether a large part of the shares are still held by financial institutions, a feature described by some authors as unique to Japanese companies (Aoki et al., 1994; Roe, 1994). Secondly, I look at the equity–asset ratio, which reflects the financing policy of each company and offers a basis to see whether the main bank system, discussed in Puchniak's Chapter 4, has remained unchanged. Thirdly, I compare the number of employees in 1988 and 2008 to add another dimension to the examination, in Wolff's Chapter 3, of changes in labour law and markets in Japan.

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[8] Sony acquired Aiwa (already a related company for a long time); KDD and DDI merged to form KDDI; and Softbank acquired Nippon Telecom and Vodafone Japan from Vodafone.

[9] For example, Astellas sold its subsidiary in the generic medicine business (Zepharma Inc.) to Daiichi Sankyo in 2006 (later merged into Daiichi Sankyo Healthcare, a subsidiary of Daiichi Sankyo).

[10] The important point is not to overlook its predecessors when tracing back the data of a company that has experienced corporate restructuring. For example, the group led by the Mitsubishi UFJ Financial holdings has 46,917 employees in total (on a consolidated basis). The number may appear to be much larger than the 8180 employed by Mitsubishi Bank in 1988. However, to perform an accurate comparison, we must add up the employees of all the financial institutions that have joined the conglomerate between 1988 and 2008.

2.1 The Major Shareholders

The *Kaisha Shikiho* reports the names of a company's three major shareholders. When going through the data for 2008, one is amazed by the large number of shares held by nominees (in the name of an agent or trustee). To be more precise, nominees appear as one or more of the three major shareholders for 37 companies among the Top 40. For six of them, all three major shareholders are trustees or agents. By contrast, banks appear as major shareholders in only three of the 40 companies. Even acknowledging that insurance companies appear as major shareholders of 16 other companies, a majority of the Top 40 companies still have no Japanese financial institution among the major shareholders.

This is very different from the situation in 1988. When we trace the Top 40 companies of 2008 and their predecessors back to the 1988 version of *Kaisha Shikiho*, 52 are found with data available.[11] Out of 52 such companies, 35 had banks as one or more of their major shareholders. If we count insurance companies as well, financial institutions appeared as major shareholders of all but two (50 out of 52).[12] Further, in 32 companies, all three major shareholders were banks or insurance companies.

The sharp contrast clearly indicates that cross-shareholdings have largely evaporated among the largest companies, as other authors have pointed out more generally (Miyajima and Kuroki, 2007). In addition, the increase in the shares held by nominees implies that institutional investors, especially foreign ones, have increased their investments in the Japanese share market. It seems that large Japanese companies are also faced with globalised capital markets, without entrenchment any more through cross-shareholdings.[13]

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[11] Namely, Toyota; Mitsubishi Trust Bank; Nippon Trust Bank; Sanwa Bank; Tokai Bank; Toyo Trust Bank; Mitsubishi Bank; Tokyo Bank; Nintendo; NTT; Canon; Sumitomo Bank; Mitsui Bank; Taiyo Kobe Bank; Daiichi Mutual Bank; Honda; Daiichi Kangyo Bank; Fuji Bank; Industrial Bank of Japan; Takeda Pharmaceutical; Sony; Aiwa; Matsushita Electric; Nissan; Mitsubishi Corp; Mitsui & Co.; Nippon Steel; Nippon Denso; Tokyo Electric Power Co.; Mitsubishi Estate; Nomura Securities; KDD; NKK; Kawasaki Steel; Komatsu; Tokio Marine and Fire Insurance; Nichido Fire Insurance; Toshiba; Teikoku Oil Co.; Fanuc; Kansai Electric Power Co.; Shin-Etsu Chemical; Ito Yokado; Seven Eleven Japan; York Benimaru; Sogo; Mitsubishi Electric; Daiichi Pharmaceutical; Sankyo Co.; Hitachi; Yamanouchi Pharmaceutical; Fujisawa Pharmaceutical; Fuji Film. Note that I do not compare the data of the Top 40 of 1988 with the Top 40 of 2008, because that would end up in comparing the data from different sets of companies.

[12] The exceptional two were Nippon Denso (currently Denso) and York Benimaru (currently a subsidiary of Seven & i Holdings).

[13] It is also understandable that Japan is now considering ratification of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary.

A response from Japanese companies has been the repurchase of shares. When the shares held by financial institutions as 'stable shareholders' were being sold off in the late 1990s, the issuing companies did not wish to have them scattered among the general investors. The situation was felt all the more threatening because the stock prices in the Tokyo market at that time were quite low. The outcome is apparent from the data, in that treasury stock appears as 'major shareholder'[14] in 14 out of the Top 40 companies in 2008. The background to the repeated requests from industry, over the 1990s, for deregulation of the repurchase of shares now becomes obvious.

2.2 Equity Ratios

Regarding the corporate finance behaviour of Japanese companies, I look at the changes in their equity ratio (equity compared with total assets). Excluding financial institutions,[15] the changes for the Top 40 companies of 2008 and their predecessors are shown in Table 10.3 below. At first sight, the average ratio has remained almost the same throughout the last two decades. However, a closer look reveals the variety among sample companies. There are companies (like Toyota and Nissan) that drastically lowered their equity ratio in the 2000s, while some others (such as Takeda Pharmaceutical and Shin-Etsu Chemical) increased the equity ratio throughout the last two decades. The equity ratio of still others has fluctuated (as with Toshiba and Mitsubishi Electric), perhaps in response to the capital and bond market situations at that time.

These observations lead to the inference that larger freedom in financing would be required to meet the variety in Japanese corporate finance behaviour (see also Sako, 2007). This has clearly been satisfied by law reforms during the past two decades (outlined in Fujita, 2004; updated in the introductory chapter). These include deregulation in the law governing corporate bonds (1993), gradual acceptance of share repurchases (late 1990s), and allowing the issuance of call options for shares (2001). These trends – giving larger freedom to companies under corporate law, together with financial sector deregulation culminating in the 'Japanese Big Bang' of 1998 (Kozuka, 2005) – underpinned the gradual transition in the law and practice of corporate finance in Japan.

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[14] 'Treasury stock' (the shareholding acquired and held by the issuing company) has no voting rights or rights to distribution of dividends (Company Law, arts 308(2) and 453). In this sense, its status as a 'major shareholder' is only superficial.

[15] Financial institutions are excluded because they are subject to unique regulation over equity ratio, such as the Basel Accord for banks. Besides, they show significantly lower equity ratios, especially in the case of deposit-taking institutions.

Table 10.3 Changes in equity ratios (%)

	1988	1993	1998	2003	2008
Toyota	64.30	64.00	69.40	37.60	36.50
Nintendo	68.50	61.90	78.60	80.40	69.40
NTT DoCoMo				53.00	71.30
NTT	32.70	57.40	43.40	29.60	40.80
Canon	49.10	44.90	63.80	54.30	66.70
Honda	43.40	50.00	58.40	37.20	38.20
Takeda Pharmaceutical	45.50	56.40	64.50	74.50	79.30
JT			73.60	53.60	40.50
Sony	60.50	47.10	52.50	28.10	28.10
Aiwa	2.00	14.20	32.50		
Matsushita Electric	55.20	54.70	55.10	37.90	51.60
Nissan	48.10	44.10	48.70	23.80	29.60
Mitsubishi Corp.	7.70	8.50	11.00	12.90	25.30
Mitsui & Co.	6.60	8.00	12.00	13.70	23.70
Nippon Steel	17.50	27.10	27.50	22.30	36.80
Denso	50.80	50.80	62.30	61.40	59.60
Tokyo Electric Power Co.	13.00	11.70	10.20	16.00	21.80
Mitsubishi Estate	37.20	26.00	24.80	27.20	35.40
East Japan Railway			10.60	14.20	22.90
KDDI				29.30	57.30
KDD	54.00	57.40	58.60		
DDI			44.90		
JFEHD					38.30
NKK	10.70	20.30	25.20	14.40	
Kawasaki Steel	18.70	30.30	28.60	14.80	
Yahoo Japan			62.60	70.20	63.70
Komatsu	45.70	52.30	58.10	29.40	45.30
Toshiba	27.50	29.60	32.30	12.60	19.00
INPEX Holdings					64.00
Teikoku Oil Co.	76.30	84.20	78.60	65.40	
Fanuc	82.90	92.30	92.20	90.80	83.90
Kansai Electric Power Co.	18.40	17.40	15.80	22.20	28.30
Softbank			41.90	31.90	7.90
Nippon Telecom			64.10	24.20	
Sin-Etsu Chemical	37.60	44.70	49.40	62.60	73.30
Seven & i Holdings					49.80
Ito Yokado	53.90	66.80	72.60	58.80	
Seven Eleven Japan	53.60	63.90	70.30	71.90	

	1988	1993	1998	2003	2008
York Benimaru	67.30	68.90	73.80	77.40	
Sogo	28.00	24.60	10.90		
Mitsubishi Electric	27.60	25.40	24.80	12.90	32.60
Daiichi Sankyo					83.60
Daiichi Pharmaceutical	51.30	56.70	65.60	79.20	
Sankyo Co.	49.30	54.80	66.60	72.00	
Central Japan Railway			7.90	12.20	17.00
Hitachi	32.10	37.50	39.50	24.50	22.60
Astellas Pharma					76.30
Yamanouchi Pharma	56.90	58.70	66.20	74.00	
Fujisawa Pharmaceutical	51.20	49.30	61.60	67.30	
Fuji Film Holdings					60.50
Fuji Film	63.60	71.80	82.40	57.90	
Average	41.91	45.38	48.68	42.77	45.74

Source: See footnote 1

2.3 Number of Employees

Another key element of the Japanese model was the labour relationship. Lifelong employment and the seniority-based wage system had been regarded as stabilisers in labour management contributing to the success of Japanese companies.[16] Although there is a general sense in Japan that such stabilisers have already been dissipated, it is not easy to ascertain whether this is true. Aoki (2007, p. 432) argues that some major companies reduced the number of permanent employees 'by using transfers of their employees to their subsidiaries and related firms, hiring freeze/cut, as well as early retirement'. However, even in the 1980s, lifelong employment did not assure employment with the parent company throughout one's career.[17] Thus, the comparison of the number of employees must be made on a consolidated basis, including all the group companies.[18] Such data, however, are not available for 1988 from the *Kaisha Shikiho* series.

[16] See Itoh (1994) for a review of relevant works.

[17] Aoki (2007) correctly adds that the reduction in the number of employees was carried out without breaking the long-term employment commitment.

[18] For example, the number of employees of Nippon Steel is 15,044 in 2008, less than a quarter of the 63 318 in 1988. However, on a consolidated basis, it had 46,143 employees in 2006. (No data are available in Toyo Keizai, 2008.) No accurate statement can be made before examining the number of employees on a consolidated basis in 1988.

Despite that caveat, some case studies may be suggestive. Table 10.4 shows the changes in the number of employees within some of the Top 40 companies from 1988 to 2008. There is variety instead of a common trend. On the one hand, there are companies that kept employment more or less constant. Companies such as Toyota, Honda and Matsushita belong to this group. Another group of companies, including Nippon Steel and Hitachi, are engaged in consistent reduction in the number of employees. The most drastic example of this group is Nissan. After the alliance with Renault, it cut down the number of employees to only 60 per cent of the number in 1988. Still others, such as Nintendo and Yahoo Japan, are instead increasing their employees. Here again, one finds gradual transformation and diversification in Japanese management (Haak and Pudelko, 2005; Jacoby, 2005c). This provides further backdrop to the developments in labour law and practice discussed in Wolff's Chapter 3.

Table 10.4 Changes in the number of employees

	1988	1993	1998	2003	2008
Toyota	64 797	75 226	71 076	66 874	69 501
Nintendo	639	890	1 009	1 206	1 467
Canon	15 924	20 186	20 336	21 584	20 937
Honda	30 487	31 561	28 284	28 308	27 277
Takeda Pharmaceutical	10 800	11 218	10 131	8 148	5 863
Sony	15 364	23 186	21 639	17 090	17 414
Matsushita Electric (Panasonic)	40 288	49 762	47 478	50 121	43 673
Nissan	53 228	55 597	40 690	31 005	32 555
Mitsubishi Corp.	8 567	10 002	8 667	6 567	6 111
Mitsui & Co.	8 846	9 219	7 731	6 426	5 892
Nippon Steel	63 318	53 049	23 228	16 989	15 044
Denso	36 562	41 591	39 717	33 998	35 211
Tokyo Electric Power Co.	40 260	41 365	43 558	37 332	36 305
Yahoo Japan			59	510	2 666
Shin-Etsu Chemical	3 357	3 751	3 299	2 716	2 555
Mitsubishi Electric	49 448	51 331	47 521	37 746	27 920
Daiichi Sankyo					5 964
Daiichi Pharmaceutical	3 281	3 779	3 998	3 786	
Sankyo Co.	5 719	6 529	6 950	6 440	
Daiichi+Sankyo	9 000	10 308	10 948	10 226	
Hitachi	77 741	83 821	71 672	47 306	40 605

Source: see footnote 1

3. CORPORATE GOVERNANCE: DIRECTORS' DUTIES AND TAKEOVERS

3.1 Limited Use of Certain Law Reforms

Other than the rules on corporate restructuring and finance, corporate governance (in its narrower sense) has been the major focus of the recent corporate law reforms. Shishido (2001, 2007) finds both 'policy-push' and 'demand-pull' types of reforms. The former includes the introduction of the optional 'board with committees' (2002, implemented from 2004), while a typical example of the latter is the partial exemption and limitation of the liability of directors (2002). Contrary to the expectation of Shishido (2007, p. 323), Lawley's Chapter 6 finds that the committee-based corporate governance form has not achieved much relevance in practice.

It is interesting to note that the 'demand-pull' reform allowing partial exemption of director's liability does not seem to be popular, either. No case has so far been reported where the exemption was granted. This outcome is not difficult to understand. The introduced system provides an 'exemption' from liability, so logically there first must be liability established, and that remains very unlikely to take place. Unlike most state corporate laws in the US (American Law Institute, 1994, pp. 256–7), in Japan, limitation of liability or indemnification by prior agreement is available only to outside directors, reportedly due to a compromise made in the course of Japan's legislative reforms (Shishido, 2007, p. 319).

3.2 The Number of Directors

Notwithstanding the lack of popularity of certain statutory systems introduced as a result of recent law reforms, corporate governance in practice did change greatly. This is reflected in the number of directors of Japanese companies. As shown in Table 10.5, the average number of Top 40 company directors in 2008 was 18.30, less than 60 per cent of their predecessors in 1988. Toyota had 50–60 directors until 2003, for example, but made a drastic cut (by nearly 50 per cent) in 2008. Similar developments occurred in other manufacturers like Nippon Steel, Toshiba and Hitachi, as well as the two trading companies (Mitsubishi Corp. and Mitsui & Co.). A board with 50 or more directors clearly cannot be efficient in making business decisions. The reduction in the number of directors, therefore, may reflect the efforts of Japanese companies to be more responsive to the changing business environment.

When reducing the number of directors, many Japanese companies introduced 'executive employees' (*Shikko Yakuin*). Unlike executive officers (*Shikkoyaku*) in companies choosing to adopt a board with committees, who

are subject to directors' duties (and potential derivative suits), these executive employees are legally mere employees governed by an employment contract with the company (Kozuka and Wolff, 2007, para. 12-700). However, the aim of introducing such titles is somewhat similar to that behind allowing the corporate form of a board with committees: to separate the executives from the decision-making organ in order to make a more efficient company.[19] It is interesting to find salient changes in corporate governance being achieved without any statutory amendments, but instead by practical revisions to the personnel system.

3.3 Liability of Directors

Another important development with regard to corporate governance law reform may be the liability of directors (Fujita, 2005). While the procedural rules for shareholders' derivative suits have been the subject of law reform since 1993, the substantive liability rules remained unchanged. In short, the latter provide that a director owes duties to act in good faith and to obey faithfully all laws, regulations, articles and resolutions of the general meeting of the company (Company Law, art. 355), which has been held to be equivalent to the duty of care as an agent of the company (Supreme Court, 24 June 1970, 24(4) Minshu, p. 625).

During the economic downturn and consequent bank and securities firm failures in the late 1990s, the government's Resolution and Collection Corporation (RCC) brought several suits against former directors on behalf of the failed banks. Through those cases, lower courts from around 2000 have developed a Japanese version of the business judgment rule. That provides the standard when considering poor business decisions taken by a director in managing a company, such as extending a loan to a borrower engaged in risky business. The rule states that a director is not liable to the company if s/he was not negligent in carrying out investigations before taking the decision, and if the decision made was not manifestly unreasonable (Kozuka and Wolff, 2007, para. 16-310). Since the courts tend to require the director to compare the costs and benefits of the alternatives available at the time of making the business decision as 'necessary investigations',[20] company directors in Japan are

[19] A difference that remains is not negligible. Even with the introduction of the status of executive employees, the board of directors has the dual role of monitoring and execution, with statutory auditors engaged in their parallel monitoring. By contrast, the board with committees concentrates on monitoring, besides making fundamental decisions.

[20] See for example, the decision by the Tokyo District Court (22 April 2002, 1793 Hanrei Jiho, p. 140) on the liability of a director of the Long-Term Credit Bank for extending loans for an unprofitable resort project.

Table 10.5 Numbers of directors (including statutory auditors)

	1988	1993	1998	2003	2008
Toyota	55	60	61	64	36
Mitsubishi UFJ Financial Group					20
Mitsubishi-Tokyo Financial Group				15	
UFJ Holdings				13	
Tokyo-Mitsubishi Bank			69		
Mitsubishi Trust Bank	34	37	37		
Nippon Trust Bank	21	22	20		
Sanwa Bank	43	48	43		
Tokai Bank	35	33	36		
Toyo Trust Bank	28	33	31		
Mitsubishi Bank	39	44			
Tokyo Bank	41	41			
Nintendo	9	10	16	18	18
NTT DoCoMo				31	17
NTT	32	39	42	16	17
Canon	26	30	29	25	32
Sumitomo Mitsui Financial Group				23	14
Sumitomo Bank	45	51	47		
Sakura Bank		66	58		
Mitsui Bank	33				
Taiyo Kobe Bank	39				
Daiichi Mutual Bank	17				
Honda	39	36	40	40	26
Mizuho Financial Group					14
Mizuho Holdings				14	
Daiichi Kangyo Bank	38	40	37		
Fuji Bank	38	42	41		
Industrial Bank of Japan	45	43	40		
Takeda Pharmaceutical	28	35	23	17	11
JT			33	12	15
Sony	35	42	42	15	13
Aiwa	15	20			
Matsushita Electric	31	36	37	31	23
Nissan	43	48	43	13	14
Mitsubishi Corp	57	54	50	22	25
Mitsui & Co.	52	55	54	12	20
Nippon Steel	52	52	49	47	18
Denso	36	41	37	36	18
Tokyo Electric Power Co.	37	39	38	36	26
Mitsubishi Estate	26	33	29	33	17
East Japan Railway			41	36	33

Table 10.5 Continued

	1988	1993	1998	2003	2008
Nomura Holdings				15	11
Nomura Securities	45	47	39		
KDDI				16	16
KDD	22	24	27		
DDI			35		
JFEHD					11
NKK	40	43	37	10	
Kawasaki Steel	33	37	28	30	
Yahoo Japan			7	8	9
Komatsu	27	31	31	12	15
Millea Holdings				18	17
Tokio Marine and Fire Insurance	33	39	43		
Nichido Fire Insurance	25	27	28		
Toshiba	28	41	38	15	14
INPEX Holdings					21
Teikoku Oil Co.	21	22	21	22	
Fanuc	28	30	31	31	18
Kansai Electric Power Co.	38	38	38	38	27
Softbank			14	13	13
Nippon Telecom			36	14	
Shin-Etsu Chemical	25	27	26	18	25
Seven & i Holdings					19
Ito Yokado	27	24	30	27	
Seven Eleven Japan	19	23	27	25	
York Benimaru	17	16	19	16	
Sogo	23	23	23		
Mitsubishi Electric	33	39	37	23	12
Daiichi Sankyo					13
Daiichi Pharmaceutical	18	23	23	24	
Sankyo Co.	23	28	32	24	
Central Japan Railway			35	34	26
Hitachi	35	37	37	19	13
Astellas Pharma					13
Yamanouchi Pharmaceutical	19	29	31	23	
Fujisawa Pharmaceutical	21	24	25	11	
Fuji Film Holdings					12
Fuji Film	24	24	25	16	
Average	31.94	35.58	34.75	22.79	18.30

Source: See footnote 1

nonetheless exposed to a not insignificant chance of being held liable for their business judgment if it later turns out to be bad.

This law on directors' liability in Japan merits two observations. First, it was case law and not the legislative process that led these developments. Secondly, the rules thus formed appear to be founded on shareholder interests and not broader 'stakeholder' theory, as indicated by the doctrine that a director is considered to be an 'agent' of the company. The result can sometimes be severe for directors of a failed company. On 28 January 2008, the Supreme Court held a former director of the failed Hokkaido Takushoku Bank liable for extending loans to a local project with little prospect for profitability.[21]

3.4 Takeover Law

Hostile takeovers can be seen as more arm's length market discipline over corporate governance, through the so-called market for corporate control. Slack corporate governance is reflected in the lower price of the company's shares, which could lead to a challenge by an acquirer committed to the more profitable management of the target company after a successful takeover.

Even after hostile takeovers became a concern for the general public, however, no statutory reaction occurred. As Dooley's Chapter 7 argues, the establishment of a non-judicial body to approve takeover bids, such as the Takeovers Panel in the UK or Australia, offers a model to address this issue, but in Japan there are hardly any calls so far for its adoption. Nor has the mandatory bid adopted by many European countries attracted the attention of the Japanese legislature. As a result, the law on takeovers in Japan has been left to case law developments, just as with the law on directors' liability.

The courts did respond to this expectation, producing a series of decisions on takeovers since the surge of hostile takeovers from 2005. The basic thrust of this case law again bears a striking similarity to the cases on director's liability: it centres on the interests of shareholders. The long-standing 'primary purpose rule' has survived, under which the target management is prohibited from taking a defensive action with the primary purpose of excluding the acquirer. An exception to this rule, added by the Tokyo High Court (23 March 2005) in the *Livedoor/NBS* case, allows defensive measures by management when the common interests of shareholders could be threatened by the acquisition. As detailed by Kamiya and Ito in Chapter 8, the Supreme Court (7 August 2007) supported the defence against a hostile bid in the *Steel*

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[21] 1997 Hanrei Jiho p. 148, also available at <http://www.courts.go.jp/search/jhsp0030?action_id=dspDetail&hanreiSrchKbn=02&hanreiNo=35633&hanreiKbn=01> (in Japanese only). See also the newspaper report by Asahi.com in English: <http://210.173.169.219/english/Herald-asahi/TKY200801280422.html>.

Partners/Bulldog Sauce case and based its judgment on the fact that a great majority of the shareholders concurred with the defensive measures. The case law in this respect could be called 'shareholder fundamentalism'.

Such reliance (possibly, over-reliance) on shareholder interests provides a sharp contrast with the general argument advanced in favour of stakeholder interests, touched on also in Pokarier's Chapter 9 in the broader context of foreign direct investment. This puzzling situation may be explicable, as Osugi (2007, p. 160) correctly points out. Shareholders and investors in Japan may take stakeholder interests into consideration and thus tend to consent to the defensive measures against hostile bidders.[22] Thus, the law – whether statutory provisions or case law – explains little when looked at in isolation.

4. CONCLUSIONS

This brief survey of various issues in Japanese corporate law and management leaves a complicated picture. Since the end of the 1980s, corporate law has changed quite a lot. Japanese companies were also changed in some respects, but not so much in others. The general tone of the corporate law reform has been deregulation and enlargement of the freedom afforded to companies, while the diversity in Japanese companies appears to have increased. It may be that the amendments to the law have enabled shifts in practice, but it may also be that changes in business necessitated the amendments in law. In addition, developments in corporate law came not only through the legislative process, which has recently become much more politicised,[23] but through case law as well. Changes in law then affect, and are affected by, the economic, political and social environment.

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[22] It should be noted that individual shareholders and many of the institutional investors were among the shareholders who consented to the defence measure in the *Bulldog Sauce* case. It cannot be explained, therefore, by the entrenchment of the management through cross-shareholding.

[23] Some academics like Iwahara (2006) argue that the recent legislative process for corporate law has become much more politicised. This is related to, but goes beyond, the new influence of corporate law reforms promoted by individual members of parliament, noted by Fujita (2004) and in the introductory chapter's Appendix. Iwahara points out, for example, that the staff within the MoJ's Civil Affairs Bureau have been increased by employing lawyers from large law firms for limited terms. There is also more pressure from *Keidanren*, associations of SMEs, and METI. The voices of political parties are increasingly echoed in the law-making. All these are new features compared with the legislative process before 1997. As Nottage's Chapter 2 remarks, these differences in policy-making processes can be defined as significant change, even if policy outcomes – let alone behaviour – do not change much or at all.

The law of closely-held companies or SMEs, taken up by Matsui's Chapter 5, reflects such complexity even more than the law for public companies. Most closely-held companies that appear in reported cases are family companies, in which the law is constantly ignored or deviated from. Courts tried to address such cases in a flexible manner to reach an equitable solution in each case, while commentators argued for legislation to provide rules that could more easily be complied with by SMEs. The practical needs of joint ventures and venture businesses came into play only in the 1990s. The issue then emerged on the policy agenda, partly motivated by the struggle for recovery in a stagnating economy. The Company Law responded by providing much greater freedom for designing closely-held company structures. This could present a new field of activity for business lawyers, helping to make society more 'judicialised', in accordance with broader reforms underway since the late 1990s to Japan's civil and criminal justice systems (Miyazawa, 2007). Yet family-owned companies still do not follow the legal requirements and, for now, do not appear to be seeking legal advice. This provides another clear example of the intertwining of politics, law and society.

In sum, therefore, this book joins other recent ones in reaching a moderate conclusion: there are no simple trends in terms of changes or developments. Everything is changing gradually and in ambiguous directions. Sometimes changes appear to occur quite rapidly, but then some steps are taken backwards, for example with directors' liability. An experience in another country offers a model, sometimes taken up as such, as with 'poison pills' against hostile takeovers. But then the innovation is absorbed into the local context, leaving a very different result from the original. Adding up such incremental and somewhat inconsistent changes may eventually bring Japanese society a long way, as has occurred in earlier historical periods (Gluck, 2007). At some point, people take a look back and find that the point where they stood only yesterday is very distant. And we know, too, that tomorrow will be another day.

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